

**CAPITAL AND REVENUE:  
RECENT AUSTRALIAN DEVELOPMENTS  
AND THE TAXATION OF LEASE INCENTIVES IN NEW ZEALAND**

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## ABSTRACT

The purpose of this thesis is twofold. The first purpose is to discuss the expansion of the concepts of income and business and the corresponding erosion of the concept of capital in Australia as a result of recent decisions of the Australian courts. The second purpose is the examination of the potential impact these Australian decisions may have in New Zealand on a specific area of taxation, the treatment for tax purposes of lease incentives.

The thesis is divided into three major parts. The first discusses generally the distinction between the concepts of income and capital. It reviews tests enunciated in various decisions on the assessability of profits and gains and deductibility of expenditure and outgoings. This discussion builds a foundation for the second and third parts of the thesis.

In the second part of the thesis I discuss a number of the recent Australian decisions on the assessability of profits and gains and one decision on the deductibility of outgoings.

The case of *F.C. of T. v. The Myer Emporium Ltd.*<sup>1</sup> is perhaps the most important recent Australian decision on the nature of income and capital in the business context. In Australia it has led to a reappraisal by commentators of the traditional income - capital distinction.

The other major Australian decision for the purpose of this paper is *F.C. of T. v. Cooling*,<sup>2</sup> which decided that a payment made to a firm of solicitors as an inducement to enter into the lease of premises was assessable to the partners of the law firm.

In the third and final section of the thesis, I consider the approach the New Zealand Inland Revenue, Taxation Review Authority and Courts may take in the

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<sup>1</sup>87 A.T.C. 4363.

<sup>2</sup>90 A.T.C. 4472.



light of the recent Australian decisions, in deciding whether cash and non-cash incentives provided to lessees are assessable. In my view the answer will probably depend on the form which the incentive takes. The goods and services tax implications of any such incentive are not covered in this thesis.

To date the principles enunciated in the Australian cases do not appear to have crossed the Tasman Sea. However the New Zealand authorities will soon have to address the issues which have been raised. The New Zealand Inland Revenue Department are currently reviewing the whole area of lease incentives. No doubt they are looking at the Australian decisions, in particular *Cooling*, with a view to their application in New Zealand.

## **INTRODUCTION**

This thesis discusses the concepts of income and capital, the recent developments in Australian case law concerning these concepts and the possible application of the principles in these cases to the taxation of lease incentives in New Zealand. The recent Australian decisions have blurred the already fine line between income and capital.

## PART A

### **INCOME vs. CAPITAL**

#### INTRODUCTION

In this section I discuss the concepts of income and capital.

Chapter I focuses on income/receipts - in particular when receipts will be characterised as having an income nature and accordingly be assessable, and conversely when receipts will be characterised as capital in nature and not assessable.

The focus then shifts to expenditure in Chapter II. Generally, items of an income nature are deductible while items of a capital nature are not deductible.

There are some exceptions, for example section 65(2)(e) of the Income Tax Act 1976 brings to income profits or gains that normally would be classified as capital in nature.

## CHAPTER I

### INCOME/REVENUE

#### 1. THE INCOME TAX ACT

(1) Income tax is imposed by section 38 of the Income Tax Act ("The Act").

Section 38(1) provides: "Subject to this Act, there shall be levied and paid for the use of the Crown for the year commencing on the 1st day of April in each year, a tax herein referred to as income tax."

Section 38(2) provides that: "income tax shall be payable by every person on all income derived by him during the year for which the tax is payable."

(2) Section 39 of the Act provides that the rate of tax for each year is fixed by the annual taxing Act.

(3) For the purposes of the Act "Person" is defined in section 2 to include "a company and a local or public authority; and also includes an unincorporated body of persons."

(4) Section 2 defines "Assessable Income" broadly to mean "income of any kind which is not exempted from income tax otherwise than by way of a special exemption expressly authorised as such by this Act".

(5) The term "Taxable Income" is also broadly defined as meaning "the residue of assessable income after deducting the amount of all special exemptions to which the taxpayer is entitled".

(6) Income tax "means income tax imposed under this Act" (section 2).

(7) The only broad definition of assessable income is in section 65. Section 65(2) provides that, without limiting in any way the meaning of the term, various categories of receipts are to be included within assessable income. Section 65(2) has a "catch all" final provision in the form of subsection (1) which includes in assessable income "Income derived from any other source whatsoever."

(8) Other sections in the Act deem certain receipts to be included within the concept of assessable income. For example, section 67 (profits or gains from the sale of land), section 78 (remitted expenses), sections 85 to 91 (trading stock) and section 107 (purchase and sale of leased assets) all deal with specific situations where a profit or gain will be assessable income to the taxpayer.

In conclusion, while the Act revolves around the concept of income, it does not precisely define what is income. Instead, it lists a large number of items that are deemed for the purposes of the Act to be income and, in case anything is missed from the list, it has a "catch all" provision where income according to ordinary concepts is deemed to be income.

## 2. THE CASES

### (1) A Comprehensive Definition?

The courts have rarely used the catch all provision to indulge in general statements about the concept of income. But they have deemed a number of receipts to be income according to ordinary concepts. For example, amounts that are received in connection with the cancellation or variation of contracts which were made in the course of carrying on business are in the nature of income.<sup>1</sup>

There are however certain forms of receipts which have yet to be argued before the courts and for which no body of decided case therefore exists. Lease incentives are an example. In New Zealand there have been no decisions to date on the tax treatment of lease incentives.

Even within well litigated areas whether a receipt is subject to tax or not will not always be clear. For example, whether an amount received as compensation for the cancellation of an agency is an income or capital receipt is, to quote *C.C.H. New Zealand Income Law and Practice*<sup>2</sup> "a question of considerable difficulty."

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<sup>1</sup>*I.R. Commrs v. Northfleet Coal and Ballast Co. Ltd.* (1927) 12 T.C. 1102; *Short Bros. Ltd. v. I.R. Commrs.* (1927) 12 T.C. 955; *Jesse Robinson and Sons v. I.R. Commrs.* (1929) 12 T.C. 1241.

<sup>2</sup>*C.C.H. New Zealand Income Tax Law and Practice*, 1993 C.C.H. New Zealand Ltd., p. 2156.

(2) "Income According to the Ordinary Concepts and Usages of Mankind"

Perhaps the classic statement on the meaning of income for tax purposes is the observation of *Jordan C.J.* in *Scott v. C. of T.* (N.S.W.).<sup>3</sup> His Honour stated:

The word 'income' is not a term of art, and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income must be determined in accordance with the ordinary concepts and usages of mankind, except in so far as the statute states or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income, or that special rules are to be applied for arriving at the taxable amount of receipts.

The statement does not define what is income according to the ordinary concepts and usages of mankind. The concept is arguably flexible in several ways:

- (a) Over time what is considered income will change.
- (b) In different places concepts and usages of income will differ.
- (c) Different elements of society will have a different view of what actually constitutes income according to the ordinary concepts and usages of mankind.

(d) A person's view of the concept depends on who the person is, i.e., whether the person is a collector or payer of tax. There is this continual tension between the revenue authorities (representing the Government) and taxpayers, whether it be business or private individuals. The Commissioner's duty is to collect taxes. As part of this the Revenue are continually attempting to expand the revenue base in two ways (i) by extending the borders of the definition of income in respect of profits or gains received, and (ii) classifying expenditure or outgoings as being capital in nature and not deductible. On the other hand taxpayers and their advisers are trying to limit the tax paid to the Revenue by endeavouring to (i) expand the definition of capital and narrow the definition of income in respect of profits or gains received and (ii) in respect of expenditure or outgoings incurred, classifying expenditure or outgoings as being of a revenue nature and therefore deductible. In this respect therefore the meaning of and distinction between income and capital is constantly in contention.

It is for all these reasons, among others that the courts and revenue

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<sup>3</sup>(1935) S.R. (N.S.W.) 215, 219.

authorities have not prescribed a comprehensive definition of income. Rather the courts and authorities have set down guidelines that can be used. However, as must always be, each case ultimately depends on its facts.

### (3) General Characteristics

The courts have identified certain characteristics which are generally associated with the concept of income. The characteristics, it should be stressed, are only a guide. The decision in each case will ultimately depend on the facts of that case. While all the characteristics of income may be present, a receipt may be of a capital nature due to the presence of other, stronger factors pointing in that direction.

The New Zealand High Court accepted in *Reid v. C. of I.R.*<sup>4</sup> that there were three principal features of income:

Mr Simcock submitted that there were three principal features of income which had become recognised in the cases. The first was that income is something which comes in (*Tennant v Smith* [1892] AC 150). The second was that income imports the notion of periodicity, recurrence and regularity (see *FC of T v Dixon* (1952) 86 CLR 540 at pp 567-568). And the third was that whether or not a particular receipt is income depends upon its quality in the hands of the recipient. (emphasis added)

(a) Income is Something which Comes In. This feature was established in the House of Lords decision of *Tennant v. Smith*. The case concerned a bank employee who as part of his duty was bound to occupy the bank house. He was not entitled to sublet the bank house or to use it for business other than that of the bank. The Court decided that the bank employee could not be assessed on the yearly value of the rent free house.

In *Lambe v. I.R. Commrs.*<sup>5</sup> Finlay J. stated: "income may be of various sorts ... but nonetheless the [income] tax is a tax on income. It is a tax on what in one form or another goes into a man's pocket. That is the general principle". Accordingly if a benefit cannot be converted into money or money's worth, then it is not something which comes in and as a result cannot be regarded as income. This is known as the

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<sup>4</sup>(1983) 6 N.Z.T.C. 61, 624 at p. 61,629 (H.C.).

<sup>5</sup>[1933] All E.R. 417.

convertibility principle which is considered later in the discussion of the Australian income tax ruling on lease incentives. (Part C, Chapter II).

A similar conclusion was reached in *F.C. of T. v. Cooke and Sherden*.<sup>6</sup> The taxpayers carried on business as "home delivery" retailers of soft drink which they purchased from the manufacturers. The drinks were re-sold to householders in allocated districts. Their business was carried on during days and periods of their own choosing. As an incentive the manufacturers operated a free holiday scheme for the retailers. The manufacturers paid the airfares and accommodation expenses for holidays for selected retailers and their wives. The holidays were not transferable and could not be cashed in. The taxpayers were assessed on the value of the holidays. The Federal Court held that the benefit of the holidays was not taxable in the hands of the retailers. The holidays were not convertible to money or moneys worth and accordingly were not a receipt of income.

In so deciding their Honours stated:

The notion that the items of income are money or are to be reckoned as money accords with the ordinary concepts of income as 'what comes into (the) pocket' to adapt Lord *Macnaghten's* phrase in *Tennant v. Smith* (1892) A.C. 150 at p. 164. That is not to say that income must be received as money; it is sufficient if what is received is in the form of money's worth (*Cross v. London and Provincial Trust Ltd.* (1938) 1 All E.R. 428 per *Greene M.R.* at p. 430). Nor is it necessary that an item of income be paid over to the taxpayer: it is sufficient, according to ordinary concepts and usages, that it be dealt with on his behalf or as he directs, as sec. 19 of the Act recognises.<sup>7</sup>

Their Honours also observed that it was immaterial that the provision of the holidays saved the taxpayers incurring expenditure. Their Honours stated:

...if a receipt of an item saves a taxpayer from incurring expenditure, the saving is not income: income is what comes in, it is not what is saved from going out. A non-pecuniary receipt can be income if it can be converted into money; but if it be inconvertible, it does not become income merely because it saves expenditure.

C.C.H.<sup>8</sup> cite the decision of *Californian Copper Syndicate Ltd. v. Harris*<sup>9</sup> as

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<sup>6</sup>80 A.T.C. 4140.

<sup>7</sup>*Ibid.*, pp. 4147 - 4148.

<sup>8</sup>C.C.H. *New Zealand Income Tax Law and Practice*, 1993 C.C.H. New Zealand Ltd., p. 2401.

<sup>9</sup>(1904) 5 T.C. 159.



showing that a receipt does not need to actually have come in before an item of income can arise. This case is dealt with in more detail in Part B. Suffice to say for this discussion, the consideration for the sale of a mining property was the allotment of fully paid up shares in the purchaser company. The Court of Exchequer (Scotland) held that the taxpayer was assessable on the value of the shares received even though no money was received.

Lord *Traynor* commented that a profit is realised when the seller receives the price that he has bargained for. In this case the taxpayer received its price although in the form of fully paid shares, (which could have been turned into cash).

It should finally be noted that not every receipt that comes in is income, for example, the proceeds from the realisation of a capital asset will not generally be income.

(b) Periodicity, Recurrence or Regularity. In *Reid v. C. of I.R.*<sup>10</sup> the Court of Appeal stated when ascertaining what is income according to the ordinary concepts and usages of mankind:

The major determinant in many cases is the periodic nature of a payment (*FC of T v Dixon* (1952) 86 CLR 540 and *Asher v London Film Productions* [1944] 1 All ER 77). If it has that quality of regularity or recurrence then the payments become part of the receipts upon which the recipient may depend for his living expenses, just as in the case of a salary or wage earner, superannuitant or welfare beneficiary. But that in itself is not enough and consideration must be given to the relationship between the payer and payee and to the purpose of the payment, in order to determine the quality of the payment in the hands of the payee.

*F.C. of T. v. Dixon*<sup>11</sup> referred to by *Reid* concerned a clerk enlisted for military service. During the period of his military service his employer paid him an amount that was equal to the difference between the rate of the military pay he received and the rate of pay he received as an employee. The amount paid was held to be income according to ordinary concepts. *Dixon* C.J. and *Williams* J. in *F.C. of T. v. Dixon* said (at p. 557):

Because the 104 [pounds] was an expected periodical payment arising out of

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<sup>10</sup>(1985) 7 N.Z.T.C. 5176.

<sup>11</sup>(1952) 86 C.L.R. 540.

circumstances which attended the war service undertaken by the taxpayer and because it formed part of the receipts upon which he depended for the regular expenditure upon himself and his dependants and was paid to him for that purpose, it appears to us to have the character of income...

This feature is however only a guide. It was accepted by the House of Lords in *Jones v. Leeming*<sup>12</sup>, for example, that assessable profits do not need to be recurrent within the year of assessment, or to be capable of recurring from year to year. The Australian High Court decision of *F.C. of T. v. Myer Emporium Ltd.*<sup>13</sup> established that the profit arising from the single business transaction in the case was income as the taxpayer's purpose in entering into the transaction was to make a profit. Again in *F.C. of T. v. Cooling*<sup>14</sup>, the Full Federal Court held a single lump sum lease incentive payment which was paid to induce a firm of solicitors to move to new rental premises was income. These cases are discussed in the second part of this thesis.

It also does not follow because receipts are of a regular nature that they will be characterised as being income. The case of *F.C. of T. v. Harris*<sup>15</sup> is a good example. The taxpayer received from his former employer four ex gratia payments to supplement his pension. It was held by the Federal Court of Australia that the first of the payments was a gift and was not an income receipt.

(c) Quality in the Hands of the Recipient. This was the third feature of income accepted by the High Court in *Reid v. C. of I.R.*

It is illustrated by the High Court of Australia case *Scott v. F.C. of T.*<sup>16</sup> A solicitor had acted for a client for many years, and had received proper remuneration for his services as a solicitor. He was given 10,000 pounds by the client. The Court decided the payment was a gift being gratuitous (in nature). It was not made to discharge an obligation and was not taken by Mr Scott as discharging an obligation.

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<sup>12</sup>[1930] A.C. 415.

<sup>13</sup>87 A.T.C. 4363.

<sup>14</sup>90 A.T.C. 4472.

<sup>15</sup>80 A.T.C. 4238.

<sup>16</sup>[1966] 117 C.L.R. 514.

The gift was referable to the attitude of the donor personally to Mr Scott personally.

The Court stated (at pp. 526 - 527):

Whether or not a particular receipt is income depends upon its quality in the hands of the recipient. It does not depend upon whether it was a payment or provision that the payer or provider was lawfully obliged to make. The ordinary illustrations of this are gratuities regularly received as an incident of a particular employment. On the other hand, gifts of an exceptional kind, not such as are a common incident of a man's calling or occupation, do not ordinarily form part of his income. Whether or not a gratuitous payment is income in the hands of the recipient is thus a question of mixed law and fact. The motives of the donor do not determine the answer. They are, however, a relevant circumstance. It is apposite to quote here a passage from the judgment of Kitto J. in *The Squatting Investment Co. Ltd. v. Federal Commissioner of Taxation* [(1953) 86 C.L.R. 570, at pp. 627,628]. His Honour said:

'... it is a commonplace that a gift may or may not possess an income character in the hands of the recipient. The question whether a receipt comes in as income must always depend for its answer upon a consideration of the whole of the circumstances; and even in respect of a true gift it is necessary to inquire how and why it came about that the gift was made.'

An unsolicited gift does not, in my opinion, become part of the income of the recipient merely because generosity was inspired by goodwill and the goodwill can be traced to gratitude engendered by some service rendered.

Under this head C.C.H.<sup>17</sup> comment that income only encompasses accretions to revenue account. Accretions that are a capital nature are not income according to ordinary concepts. Lord MacNaughten in *London County Council v. A-G*<sup>18</sup> commented "income tax is always a tax on income".

In the United States Supreme Court case *Eisner v. Macomber*<sup>19</sup> Pitney J. made the following observations in respect of the distinction between income and capital gains:

... The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree on the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream to be measured by its flow during a period of time... Here we have the essential matter; not a gain accruing to capital; not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed, and coming in, being 'derived' - that is received or

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<sup>17</sup>C.C.H. *New Zealand Income Tax Law and Practice*, 1993 C.C.H. New Zealand Ltd., p. 2042.

<sup>18</sup>[1901] A.C. 26.

<sup>19</sup>(1919) 252 U.S. 189.

drawn by the recipient (the taxpayer) for his separate use, benefit and disposal - that is income derived from property. Nothing else answers the description.

C.C.H.<sup>20</sup> state on the basis of *Pitney J.*'s observations, which were quoted with approval by Viscount *Finlay* in *I.R. Commrs. v. Greenwood*<sup>21</sup>, that the sale of an asset for a profit, "the tree", without more, would produce a gain of a capital nature. Accordingly the courts have held that the proceeds of a mere realisation of a capital asset or a change of investment are not regarded as producing gains of an income nature. By contrast assets used in a successful profit-making scheme generally will produce gains that are income. An early authority for this distinction is *Californian Copper Syndicate Ltd. v. Harris*.<sup>22</sup>

In this respect, in *Ryall v. Hoare*,<sup>23</sup> *Rowlatt J.* said:

...it is quite clear that anything in the nature of a capital accretion is outside the words 'profits or gains', as used in these [income tax] Acts; that of course, follows from the scope of the Act, and it is sanctified by the usage now of a century. That rules out, of course, the well-known case of a casual profit made upon an isolated buying and selling of some article; that is a capital accretion, and unless it is merged with other similar transactions in the carrying on of a trade, and the trade is taxed, no tax is eligible in respect of a transaction of that kind. 'Profits or gains' mean something which is in the nature of interest or fruit, as opposed to principal or tree.

The relevance of the quality of the receipt in the hands of the recipient is illustrated in a recent decision of the Australian Full High Court, *G.P. International Pipecoaters Pty. Ltd. v. F.C. of T.*<sup>24</sup> This case is discussed in detail in a later section in this thesis. The taxpayer company was paid three sums of money for the construction of a plant. The Full High Court said the amount paid must be classified as an income receipt. The Court said:

The relevant question is whether the receipt of the establishment costs was income in the taxpayer's hands. It is necessary to keep that question steadily in mind and not to confuse the character of the receipt with the nature of the asset acquired by application of the money received.

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<sup>20</sup>C.C.H. *New Zealand Income Tax Law and Practice*, 1993 C.C.H. New Zealand Ltd., p. 2042.

<sup>21</sup>(1921) 8 T.C. 10.

<sup>22</sup>(1904) 5 T.C. 159.

<sup>23</sup>(1923) 8 T.C. 521.

<sup>24</sup>90 A.T.C. 4413.

### 3. CONCLUSION

(1) The word or concept "income" is not defined in the Income Tax Act. Section 65(2) provides that certain categories of receipts are to be included within assessable income. There are other provisions in the Act which provide that certain receipts are assessable income.

(2) The Courts have not defined the term "income". Rather they refer to "income according to the ordinary concepts and usages of mankind".

(3) Three principle features of income have been identified by the courts:

- (a) income is something which comes in;
- (b) income imports the notion of periodicity, recurrence and regularity; and
- (c) whether a receipt is income depends on its quality in the hands of the recipient.

These characteristics are only to be used as a guide to distinguishing between income and capital.

## CHAPTER II

### EXPENDITURE: CAPITAL OR REVENUE?

#### 1. THE INCOME TAX ACT

Section 101 of the Income Tax Act provides that no deductions shall be made for any expenditure or loss for the purpose of calculating assessable income except as expressly provided in the Act.

The general deductibility provision is section 104 which provides:

In calculating the assessable income of any taxpayer, any expenditure or loss to the extent to which it -

- (a) Is incurred in gaining or producing the assessable income for any income year; or
- (b) Is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year -

may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer in the income year in which the expenditure or loss is incurred.

Section 106 provides that certain deductions are not permitted. The most significant prohibition in the section for the purposes of this thesis is that of section 106(1)(a) which prohibits a deduction for expenditure or loss of a capital nature.

#### 2. TESTS OUTLINED BY THE COURTS

A number of tests have been formulated by the courts to determine the nature of an expenditure or loss.

The Privy Council case of *B.P. Australia Ltd. v. Commr. of Taxation of the Commonwealth of Australia*<sup>1</sup> is considered to be the landmark case outlining the approach to determine the nature of an outgoing. The case concerned the payment by B.P. of a sum of money in consideration for the service station proprietor agreeing to

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<sup>1</sup>[1966] A. C. 224

deal exclusively for a fixed number of years in motor spirit brands approved by B.P. B.P. claimed a deduction for the payments made. The Court found the expenditure to be revenue.

In the *B.P. Australia* case Lord *Pearce* noted the solution to the problem of determining the nature of a payment was not to be found in any rigid test or description, rather it was to be derived from many aspects of the whole set of circumstances. He also noted:

As each new case comes to be argued felicitous phrases from earlier judgments are used in argument by one side and the other. But those phrases are not the deciding factor, nor are they of unlimited application. They merely crystallise particular factors which may incline the scale in a particular case after a balance of all considerations has been taken.<sup>2</sup>

A number of tests have now been formulated by the cases to determine the nature of an outgoing or loss. They include:

- (1) Recurrence;
- (2) Whether the expenditure was made not only once and for all but with a view to bringing into existence an asset or advantage for the enduring benefit of a trade (the "enduring benefit" test);
- (3) The distinction between the business structure and the process by which the business operates to obtain regular returns by means of regular outgoings.
- (4) The distinction between fixed and circulating capital;
- (5) The nature of the asset obtained or sought in which its enduring character may play a part (the "identifiable asset" test);
- (6) Commercial or Accounting Principles.

In looking at the various tests, it has been stressed in numerous cases, that a commonsense approach must be taken, the facts and circumstances of each particular case must be analysed, and while the cases are only a guide, "nevertheless reported cases are the best tools that we have, even if they may sometimes be blunt instruments".

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<sup>2</sup>Ibid., p. 265.

### 3. A DISCUSSION OF SPECIFIC TESTS

#### (1) Recurrent and Once and For All Payments

A recurring expense suggests that it is part of the cost of the ordinary business operations and therefore a revenue outlay. On the other hand a once and for all payment generally, but not always, points to an outgoing of a capital nature. The test originated in the case of *Vallambrosa Rubber Co. Ltd. v. Farmer*.<sup>3</sup> The President of the Court of Session, Lord *Dunedin* said in that case (at p. 536):

I do not say that this consideration is absolutely final or determinative; but in a rough way I think it is not a bad criterion of what is capital expenditure to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year.

The test was approved by the House of Lords in *British Insulated and Helsby Cables Ltd. v. Atherton*.<sup>4</sup> Lord *Cave* in that case noted that Lord *Dunedin* had not intended that the criterion be the decisive one in every case.

In *B.P. Australia*, on the issue of recurrence of the payments Lord *Pearce*<sup>5</sup> commented:

What additional indication is given by the actual length of the agreements? That must be a question of degree. Had the [trade-tie] agreements been only for two or three year periods, that fact would have pointed to recurrent revenue expenditure. Had they been for twenty years, that fact would have pointed to a non-recurring payment of a capital nature. Length of time, though theoretically not a deciding factor, does in practice shed a light on the nature of the advantage sought. The longer the duration of the agreements, the greater the indication that a structural solution was being sought. (emphasis added)

A period of five years in that case was neutral, indicating neither capital nor revenue expenditure.

A refinement to or restatement of Lord *Dunedin's* test was provided in *Ounsworth v. Vickers*<sup>6</sup>. Commenting on Lord *Dunedin's* test Rowlatt J. stated (at p. 273): "...no stress is there laid upon the words 'every year': the real test is between

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<sup>3</sup>(1910) 5 T.C. 529.

<sup>4</sup>[1926] A.C. 205 at p. 213.

<sup>5</sup>[1966] A.C. 224.

<sup>6</sup>[1915] 3 K.B. 267.



expenditure which is made to meet a continuous demand, as opposed to an expenditure which is made once and for all."

The test is limited in application. This has been recognised in a number of cases and led to further tests being formulated.

## (2) The Enduring Benefit Test

But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.

per Lord *Cave* in *British Insulated and Helsby Cables Ltd. v. Atherton*.<sup>7</sup>

The taxpayer company established a pension fund for its clerical and technical salaried staff. The taxpayer claimed a deduction for the sum of 31,784 pounds paid by it to form the nucleus of the fund. The House of Lords by a majority held that the payment was in the nature of capital expenditure and not deductible.

The payment came within the enduring benefit test because the object and effect of the payment was to enable a pension fund to be established by the company and to offer to existing and future staff a provision for their old age. The company obtained the substantial and lasting advantage of being able to secure and retain happy and efficient staff. In the words of Lord *Reid* in *B.P. Australia* "it kept their servants in good heart".

The New Zealand Court of Appeal accepted the test in New Zealand in *Kemball v. C. of T.*<sup>8</sup> Their Honours decided a movie theatre business could not deduct the premiums payable upon execution of ten year leases for hiring projection equipment. No deduction was permitted because the premiums brought into existence an asset for the enduring benefit of that business. It was contended that the machines and equipment the subject of the agreements, could not become the appellant's property and therefore could not be called an asset of the appellant. Their Honours disagreed stating (at p. 1309):

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<sup>7</sup>[1926] A.C. 205.

<sup>8</sup>[1932] N.Z.L.R. 1305.

The appellant derives an advantage even if he has not acquired an asset. But he has the right to retain and use the machines and equipment subject to the terms of the agreements and to sell his business at an enhanced price because of his right to use the machine, and this surely is an asset.

It was also contended that the asset was not acquired for the enduring benefit of the appellant's trade or business because the appellant's rights existed for only ten years. Their Honours said:

That seems to us to be immaterial. No plant, machinery, or equipment acquired for the purposes of any trade or business can be expected to last forever. It has to be renewed at some period, which may be many or a comparatively few years, but none the less it is acquired and intended for the enduring benefit of the trade or business.

A deduction is now available under section 139 for expenditure incurred in similar circumstances.

The Privy Council in *B.P. Australia* stated that the term "enduring" did not mean it lasted forever. This can be seen from *Kemball's* case where the leases on which the premiums were paid were for ten years. In *Regent Oil Co. Ltd. v. Strick*<sup>9</sup>, which also concerned the deductibility of payments made pursuant to a trade-tie, Lord Reid commented (at p. 186) that: "I would have great difficulty in regarding a payment to cover 20 years as anything other than a capital outlay".

However not in every case where expenditure brings into existence an asset or an advantage for the enduring benefit of a business will the expenditure be capital. In this regard, the Privy Council in *B.P. Australia* referred to the case of *Rhodesia Railways Ltd. v. Collector of Income Tax*<sup>10</sup> where payments for the renewal of the sleepers and the track were a revenue character and affected the value of the business. The renewal increased the value of the enterprise as a whole, nonetheless, the payments were held to be a revenue not a capital outgoing.

### (3) The Distinction between the Business Structure and the Business Process

Expenditure which is incurred in relation to the business (or profit yielding)

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<sup>9</sup>[1965] 3 All E.R. 174.

<sup>10</sup>[1933] A.C. 368.

structure may be regarded as capital expenditure. Expenditure on the other hand, incurred in relation to the business process i.e., the process by which that entity operates, may be regarded as a revenue item.

This principle applies to expenditure that is incurred in establishing, replacing or enlarging the business structure and involves a similar concept to the distinction between fixed and circulating capital. This distinction can give rise to difficulties in its application, in particular in respect of expenditure incurred to protect the business structure.

The classic authority for the distinction is the judgment of *Dixon J.* in *Sun Newspapers Ltd. v. F.C. of T.*<sup>11</sup> The taxpayer company published newspapers in Sydney including an evening paper. Another evening paper in Sydney, "the World", sold for the same price per copy. It was announced that some parties connected with "the World" were going to publish another evening newspaper that would sell for a lower price per copy. To prevent that newspaper from being published the taxpayer agreed to pay a sum of 86,500 pounds as the price of the owner's interest in "the World" and, in return, those owners agreed to bind themselves not to publish another newspaper within 300 miles of Sydney for a period of three years. The Full High Court of Australia said that no deduction was available and that the whole sum was an outgoing of a capital nature.

*Dixon J.* (at pp. 359-360) expressed the distinction between the profit yielding structure and the income earning process in the following terms:

The distinction between expenditure and outgoings on revenue account and on capital account corresponds with the distinction between the business entity, structure, or organization set up or established for the earning of profit and the process by which such an organization operates to obtain regular returns by means of regular outlay, the difference between the outlay and the returns representing profit or loss. The business structure or entity or organization may assume any of an almost infinite variety of shapes and it may be difficult to comprehend under one description all the forms in which it may be manifested.

In some businesses where little or no plant was required, the business structure could be represented by intangible items constituting goodwill, while other businesses

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<sup>11</sup>(1938) 61 C.L.R. 337.

could consist of a considerable number of tangible assets, such as buildings, plant and machinery.

But in spite of the entirely different forms, material and immaterial, in which it may be expressed, such sources of income contain or consist in what has been called a 'profit yielding subject', the phrase of Lord *Blackburn* in *United Collieries Ltd. v. I.R. Commrs.* (1929) 12 T.C. 1248 at p. 1254.

He also stated while as general conceptions it may not be difficult to distinguish between the profit yielding structure and income earning process, "the practical application of such general notions is another matter".

*Dixon J.* went on to say that three matters were to be considered in determining the nature of a payment (at p. 363):

There are, I think, three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.

He concluded that the transaction strengthened and preserved the profit yielding subject and affected the capital structure. In reaching this conclusion his Honour relied upon several factors including:

(a) The expenditure was a large sum that was incurred to remove finally, threatened competition.

(b) The main object of the expenditure was to preserve from immediate impairment and dislocation the existing business organisation.

(c) The transaction concerned the acquisition of a going concern for a fixed period, which was recognised as a capital asset.

Examples of where the distinction between the profit yielding structure and the profit earning process have been referred to and relied on include, *Broken Hill Theatres Pty. Ltd. v. F.C. of T.*<sup>12</sup> and *John Fairfax and Sons Pty. Ltd. v. F.C. of T.*<sup>13</sup>

In *Broken Hill Theatres*, the taxpayer incurred legal costs in successfully

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<sup>12</sup>(1952) 85 C.L.R. 423.

<sup>13</sup>(1959) 101 C.L.R. 30.

opposing the application of a rival for a movie theatre licence. In so doing the taxpayer secured 12 months freedom from competition. The Full High Court of Australia held the expenditure was incurred to preserve and protect the business of the company and accordingly was on capital account.

*John Fairfax* concerned the taxpayer company who was competing with another newspaper company to acquire the shares of a third newspaper company. The rival bidder brought an action against the taxpayer seeking to have the share allotment made to the taxpayer set aside. Legal costs were incurred by the taxpayer in defending this action. The High Court decided no deduction was available as the costs were a capital outgoing. *Dixon* C.J. believed the litigation gave rise to expenditure which was exclusively concerned with the organisation and structure of the profit earning enterprise. *Menzies* J. stated that the advantages sought to be obtained from the expenditure were related to the profit bearing subject rather than to its operation.

The test was recognised in New Zealand in *Buckley and Young Ltd. v. C. of I.R.*<sup>14</sup> The case concerned payments made to remove a director and obtain a restrictive covenant from him not to compete with the company. The Court of Appeal held that the payments were comprised of both a capital and an income component. As the taxpayer did not discharge the onus of showing how the apportionment between the two should be made no deduction was available. In the course of its judgment the Court recognised the distinction between the business structure and income earning process.

Again in the course of his judgment in *de Pelichet McLeod and Co. Ltd. v. C. of I.R.*,<sup>15</sup> *Richardson* J. stated: "But there is a fundamental distinction between the source of income and the income yielding process. Expenditure to make the future earning of profits possible is of a different character from expenditure incurred as

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<sup>14</sup>(1978) 3 N.Z.T.C. 61,271.

<sup>15</sup>(1982) 5 N.Z.T.C. 61,216.

part of the process of earning profits."<sup>16</sup>

A limitation of the test was pointed out in the Privy Council decision *C. of T. v Nchanga Consolidated Copper Mines Ltd.*<sup>17</sup> The Board found the distinction between the concepts of profit yielding structure and income earning process to be blurred. In that case the taxpayer company claimed a deduction for a sum paid to another copper mining company for it to cease production for a year. The payment was prompted by a drop in copper prices. The object of the payment was to boost prices by reducing the over all production of copper. The copper producers who continued mining agreed to pay compensation to the producer who ceased production. At issue was whether a deduction was available for the taxpayer's share of the compensation paid. The Council found that the expenditure in question was an allowable deduction.

In reaching their decision the Board made some general observations on various tests which are applied in distinguishing between income and capital. Viscount *Radcliffe* said:

Again courts here stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve, but the reality of the distinction, it must be admitted, does not become the easier to maintain as tax systems in different countries allow more and more kinds of capital expenditure to be charged against profits by way of allowances for depreciation, and by so doing recognise that at any rate the exhaustion of fixed capital is an operating cost. Even so, the functions of business are capable of great complexity and the line of demarcation is sometimes indeed difficult to draw and leads to distinctions of some subtlety between profit that is made 'out of' assets and profit that is made 'upon' assets or 'with' assets.

#### (4) Fixed and Circulating Capital

Expenditure that relates to fixed capital is generally regarded as capital in nature, while expenditure relating to circulating capital is conversely treated as being of a revenue nature. Fixed capital concerns the fixed plant that provides the

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<sup>16</sup>Ibid., 61,219.

<sup>17</sup>[1964] 1 All E.R. 208.

potential for profits or gains to be made. Circulating capital is that capital which is turned over in the course of profit-making. This distinction involves a similar concept to the distinction between the business structure and profit earning process already discussed.

In *B.P. Australia* the Board briefly mentioned this test and said: "This test of fixed and circulating capital is not always helpful and not always easy to apply or appropriate; in some circumstances it can be critical, but in others it is not very easy to use or to apply; it is not very significant."<sup>18</sup>

The test was formulated in *John Smith and Son v. Moore*<sup>19</sup> and considered in *C. of T. v. Nchanga Consolidated Copper Mines Ltd.*<sup>20</sup>

In *John Smith*, the father of the taxpayer carried on business as a shipping and coal merchant. He contracted with colliery owners to purchase coal at a fixed price. He then sold the coal to consumers at the price prevailing after delivery. Following the death of his father the taxpayer paid 30,000 pounds to acquire the unexpired coal contracts at the date of his father's death. The coal was sold for a considerably higher price than the price in the contracts. The taxpayer carried on his father's business and claimed a deduction for the 30,000 pounds he had paid to acquire the coal contracts. By a majority the House of Lords held the expenditure to be of a capital nature and not deductible.

The issue for Viscount *Haldane* was whether the contracts were circulating capital. He referred to Adam Smith who "described fixed capital as what the owner turns to profit by keeping it in his own possession, circulating capital as what he makes profit of by parting with it and letting it change masters."<sup>21</sup> Viscount *Haldane* found the contracts to be part of the taxpayer's fixed capital:

[The taxpayer] made profit with circulating capital by buying coal under the contracts he had acquired from his father's estate at the stipulated price of

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<sup>18</sup>[1966] A.C. 224 at p. 336.

<sup>19</sup>[1921] 2 A.C. 13 at p. 19.

<sup>20</sup>[1964] 1 All E.R. 208.

<sup>21</sup>[1921] 2 A.C. 13 at p. 20.

fourteen shillings and reselling it for more, but he was able to do this simply because he had acquired, among other assets of his business, including the goodwill, the contracts in question. It was not by selling these contracts, of limited duration though they were, it was not by parting with them to other masters, but by retaining them, that he was able to employ his circulating capital in buying under them. I am accordingly of opinion that, although they may have been of short duration, they were none the less part of his fixed capital.

In dissenting, Viscount *Finlay* believed the 30,000 pounds involved an outlay of circulating capital, the coal contracts not being distinguishable from the coal they represented.

In *C. of T. v. Nchanga Consolidated Copper Mines Ltd.*, the Privy Council emphasised the peculiar facts in the *John Smith* case. In particular the fact that the contracts were not in a form that allowed them to be treated as analogous to stock in trade. The Board indicated that it was not a sound general proposition that a purchaser of a business should always treat the value of the trading stock acquired as capital expenditure.

This distinction has been applied in *Mallett v. Staveley Coal and Iron Co. Ltd.*<sup>22</sup> The taxpayer company carried on a coal mining business. The company paid the sum of 6,500 pounds to be released from all its obligations under two mining leases. The sum was held to be an outgoing of a capital nature by the English Court of Appeal. The sum was paid in respect of the taxpayer's fixed capital, by which the right to mine coal was secured to the company. The payment was not made in respect of circulating capital. Lord *Hanworth* M.R. said:

...one has to keep clear in one's mind that in dealing with any business one has two sorts of capital, one the fixed capital which is laid out in the fixed plant, whereby the opportunity of making profits or gains is secured, and the other the circulating capital, which is turned over and over in the course of the business which is carried on.

A different result was reached in the case of *Anglo-Persian Oil Co. Ltd. v. Dale*.<sup>23</sup> As already briefly discussed, the case concerned the sum of 300,000 pounds paid by the taxpayer company to terminate an agreement it had with one of its agents. Following the cancellation the taxpayer acted for itself in distributing its oil

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<sup>22</sup>(1928) 9 T.C. 772.

<sup>23</sup>(1931) 16 T.C. 253.



products. This saved the company considerable sums of money. The Court of Appeal regarded the payment as a means of ending an expensive mode of carrying on its business. The payment was accordingly not an outgoing of a capital nature. In his judgment *Lawrence* L.J. rejected the suggestion that the company had acquired an asset or an advantage for the enduring benefit of its trade. The payment was advantageous to the company however it did not create an advantage for the enduring benefit of the trade of the company. This was because at any time it might revert to the former method by which it conducted its business.

The distinction between fixed and circulating capital has been criticised in other cases as being of limited assistance. Lord *MacMillan* in *Van den Berghs Ltd. v. Clark*<sup>24</sup> remarked that he had "not found it [the distinction] very helpful" in that case. In *Reynolds and Gibson v. Crompton*,<sup>25</sup> *Jenkins* L.J. observed that Lord *MacMillan* in *Van den Berghs* case did not think that "the somewhat debatable distinction between fixed and circulating capital really contributes anything to the solution of the question in issue". Indeed "...the line of distinction between fixed and circulating capital is not precisely drawn, and it is of little advantage to try to answer one question by asking another to which the answer may be uncertain". (per *Gibbs* J. in *Commercial and General Acceptance Ltd. v F.C. of T.*)<sup>26</sup>

#### (5) The Identifiable Asset Test

Under the test an outgoing will be treated as being of a capital nature where an asset of a capital nature, albeit tangible or intangible, has been acquired by that outgoing. Lord *Reid* in *Regent Oil Co. Ltd. v. Strick*<sup>27</sup> stated the principle as follows: "if an asset which is acquired is in its intrinsic nature a capital asset, then any sum paid to acquire it must surely be a capital outlay".

The test is clearly stated by Lord *Wilberforce* in *Tucker v. Granada Motorway*

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<sup>24</sup>[1935] A.C. 431.

<sup>25</sup>[1950] 2 All E.R. 502 at p. 511.

<sup>26</sup>77 A.T.C. 4375 at p. 4377.

<sup>27</sup>[1965] 3 All E.R. 174.

*Services Ltd.*<sup>28</sup> At issue was whether the taxpayer company could deduct a large payment it had made to obtain a reduction in the rent payable for premises from which it carried on its service station business. The lease was for a term of 50 years. The renegotiated rent took effect after the lease had been running for 10 years.

In his judgment Lord *Wilberforce* stated the payment could be viewed one of two ways. On one hand the payment was designed to enable the taxpayer to earn greater profits and therefore it could be thought of as having a revenue character. On the other hand, the payment resulted in the lease being modified. The lease could be regarded as an identifiable asset. The payment made the lease less disadvantageous. From this point of view it might be thought that the payment should be regarded as of a capital nature. He stated:

I think that the key to the present case is to be found in those cases which have sought to identify an asset. In them it seems reasonably logical to start with the assumption that money spent on the acquisition of the asset should be regarded as capital expenditure. Extensions from this are, first, to regard money spent on getting rid of a disadvantageous asset as capital expenditure and, secondly, to regard money spent on improving the asset, or making it more advantageous, as capital expenditure. In the latter type of case it will have to be considered whether the expenditure has the result stated or whether it should be regarded as expenditure on maintenance or upkeep, and some cases may pose difficult problems.

Lord *Wilberforce* cited the *Regent Oil* and *B.P. Australia* cases and stated that in those cases (at p. 805): "The test there accepted and applied was whether a capital asset could be identified for which the relevant payments were made." These cases supported he said, the identifiable asset test.

Lord *Wilberforce* found that the payment was a payment of a capital nature. The lease was a capital asset of the taxpayer. The case was therefore one of a once and for all expenditure on a capital asset which was designed to make it more advantageous.

It should be noted in both *Regent Oil* and *B.P. Australia* the Courts examined a number of tests to distinguish between income and capital payments.

Stronger support for the test is to be found in *Commrs. of I.R. v. Carron*

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<sup>28</sup>[1979] 2 All E.R. 801.

*Company*.<sup>29</sup> In that case, expenditure was incurred in order to procure a modification of the company's charter which was impeding the profitable development of the company's business. The payment was held by the House of Lords to be of a revenue nature. The House rejected the Crown's view that the expenditure was of a capital nature because the payment secured a substantial alteration in the structure of the company.

Lord Reid stated in *Carron* (at p. 68):

In a case of this kind what matters is the nature of the advantage for which the money was spent. This money was spent to remove antiquated restrictions which were preventing profits from being earned. It created no new asset. It did not even open new fields of trading which had previously been closed to the company. Its true purpose was to facilitate trading by enabling the company to engage a more competent manager and to borrow money required to finance the company's traditional trading operations under modern conditions. None of the authorities cited is directly in point, and I think that the most apposite general statement in those authorities is that of *Lawrence L.J.* in *Anglo-Persian Oil Co. Ltd. v. Dale* [1932] K.B. 124, at page 141. It 'merely effected a change in its business methods and internal organisation, leaving its fixed capital untouched'.

As was pointed out by Lord Guest "there was nothing in this case in the shape of the acquisition of a capital asset".

*C.C.H. New Zealand Income Tax Law and Practice* notes,<sup>30</sup> that the *Carron Company* decision illustrates that the identifiable asset test may produce a different result from that which may be achieved under the other tests. The expenditure concerned the modification to the business structure. As a result it produced a significant advantage for the enduring benefit of the company's business. Both the tests of enduring benefit and business structure would indicate that the expenditure was of a capital nature. The House however regarded the lack of the creation of a capital asset as indicating the expenditure was not on capital account.

The identifiable asset test was followed in *C. of I.R. v. McKenzies N.Z. Ltd.*<sup>31</sup> This case is dealt with in detail in the third section of this thesis. The case considered whether a lump sum payment made by a lessee (McKenzies) to secure the

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<sup>29</sup>(1968) 44 T.C. 18.

<sup>30</sup>*C.C.H. New Zealand Income Tax Law and Practice*, 1993 C.C.H. New Zealand Ltd., p. 14,752.

<sup>31</sup>(1988) 10 N.Z.T.C. 5233.

surrender of an onerous lease was deductible. In deciding that the payment was not deductible the Court of Appeal decided the issue according to general taxation principles. The lease was a capital asset. This capital nature determined the character of the expenditure associated with the disposal of the asset. In the absence of complicating factors that would point to a different result, the lump sum payment made to surrender the lease was of a capital nature and not deductible.

#### (6) Commercial or Accounting Principles

This is a further test used to determine the nature of an outgoing. An expenditure or loss may be characterised as a capital outgoing where commercial or accounting principles suggest that is the way the outgoing should be characterised. This test according to *C.C.H. New Zealand Income Tax Law and Practice*<sup>32</sup> is mainly an English doctrine which is only infrequently mentioned in New Zealand decisions. C.C.H. suggest a possible reason for this being that the questions involving capital and income which are litigated generally raise novel issues which are outside the range of established principles. Additionally there may be controversy over what are the true commercial or accounting principles.

These principles are more frequently used to calculate actual profits or gains subject to income tax. C.C.H. give several examples where this test has been used. One of these examples is the Taxation Review Authority (T.R.A.) decision in *Case F60*.<sup>33</sup> The case concerned a farmer who was required by the terms of his lease to erect a dwelling on the property that he farmed. He moved a substandard house onto the farm property and then expended money reconstructing the house. The T.R.A. disallowed the deduction claimed for the cost of the reconstruction. The T.R.A. stated: "The expenditure related to an asset which of its very nature, on the basis of accepted accounting principles and indeed on the basis of commonsense, can only be regarded as a capital item".

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<sup>32</sup>*C.C.H. New Zealand Income Tax Law and Practice*, 1993 C.C.H. New Zealand Ltd., p. 14,230.

<sup>33</sup>(1983) 6 N.Z.T.C. 59,885.

#### 4. CONCLUSION

(1) Section 104 of the Income Tax Act allows a deduction for any expenditure or loss incurred in gaining or producing assessable income or incurred in carrying on a business for the purpose of gaining or producing assessable income.

(2) Deductions for expenditure or losses of a capital nature are however prohibited by Section 106(1)(a) of the Act.

(3) The courts have formulated a number of tests to determine whether an item of expenditure or loss is a revenue item, and therefore deductible, or capital, and not deductible. The landmark case in this area is *B.P. Australia Ltd. v. F.C. of T.* As with the characterisation of receipts dealt with in chapter I the distinction is not always easy to make.

(4) Of the tests discussed in the thesis, the main tests are:

(a) Recurrent and Once and For all Payments. If expenditure is recurrent this suggests that it is a cost of the ordinary business operations and therefore of a revenue nature. Conversely a once and for all payment may point to it being of a capital nature.

(b) The Enduring Benefit Test. Expenditure will, in the absence of special circumstances, be regarded as of a capital nature where it is made to bring into existence an asset or advantage, tangible or intangible, for the enduring benefit of a trade or business.

(c) The Distinction between Business Structure and Process. Expenditure incurred in relation to the business structure may be regarded as capital expenditure, while expenditure incurred in relation to the business process may be regarded as a revenue item.

(5) Other tests include:

- (a) The distinction between fixed and circulating capital.
- (b) The identifiable asset test.
- (c) Commercial or accounting principles.

As with the characterisation of receipts in Chapter I, at the end of the day

each case however turns on its own facts.

In the ensuing sections many of the principles in Chapter 1 and this Chapter are discussed.

## PART B

### RECENT AUSTRALIAN DECISIONS

#### INTRODUCTION

In this section the focus is on the expansion of the concepts of income and business and corresponding erosion of the concept of capital in recent Australian decisions.

The landmark decision in this area is that of the Full High Court of Australia in *F.C. of T. v. The Myer Emporium Ltd.*<sup>1</sup> It has required a reappraisal of the traditional distinctions between income and capital.

Since the High Court's decision in 1987 there has been a number of decisions which have discussed and applied the principles enunciated in *Myer*. Some of these decisions are discussed in this section. One of these, *F.C. of T. v. Cooling*<sup>2</sup>, concerned the provision of a lease incentive to a firm of solicitors.

Some cautionary notes have also been sounded in subsequent decisions in respect of the correct interpretation of the principles in *Myer*. A number of commentators have criticised the correctness of the *Myer* decision. These comments and criticisms are also noted in this section.

The principles enunciated in the *Myer* and *Cooling* cases may be relevant to the tax treatment of lease incentives in New Zealand discussed in Part C, if the New Zealand courts decide to follow the Australian decisions.

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<sup>1</sup>87 A.T.C. 4363.

<sup>2</sup>90 A.T.C. 4472.

## CHAPTER I

***F.C. of T. v. THE MYER EMPORIUM LTD.*<sup>1</sup>**

## 1. INTRODUCTION

On 14 May 1987 the Full High Court [of Australia] handed down its decision in the case of *Commissioner of Taxation v The Myer Emporium Ltd.*

The occasion was not accompanied by a great fanfare of trumpets: it was scarcely noted by the newspapers and the reporting services did not react with their usual promptitude in producing a report of the case for the benefit of the profession. Yet, it may confidently be asserted that the decision represents a landmark in tax jurisprudence and will be of continuing significance long after its expensive consequence to the respondent to the appeal are forgotten.<sup>2</sup>

This chapter discusses the *Myer* case, specifically the decision of the Full High Court which is perhaps the most important recent Australian decision that discusses the concepts of income and capital in the business context. In Australia it has led to a reappraisal by commentators of the traditional income - capital distinctions.

The decision rests on two strands of reasoning:

(1) A receipt may constitute income if it arises from an isolated business operation or from a commercial transaction entered into otherwise than in the course of carrying on the business of the taxpayer, so long as the taxpayer entered into the transaction with the purpose of making a relevant profit or gain from the transaction.

(2) If the lender sells his mere right to interest for a lump sum, the lump sum is received in exchange for, and ordinarily as the present value of, the future interest which he would have received. This is a revenue not a capital item - the taxpayer simply converts future income into present income. (at p. 4371)

As a result of these two strands, in particular the first, the concept of income has been expanded at the expense of the concept of capital by the Full High Court.

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<sup>1</sup>87 A.T.C. 4363.

<sup>2</sup>Hill, *A Pre-Bicentennial Reminder of Our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 *Taxation in Australia*, No. 1, p. 12.



(1) - Background to the High Court Decision

During 1980 the board of directors of the Myer Emporium Ltd considered reorganising the Myer group of companies with the result that the retail and property arms would be separated. The reorganisation proposal included the formation of a property trust. This was abandoned when, on 11 July 1980 the Treasurer announced, and soon after detailed, the decision of the Commonwealth Government to tax (at the company tax rate) all income of public unit trusts established as part of a company reorganisation.

In a report dated 28 August 1980 Myer's advisors, Hill Samuel Australia Ltd ("Hill Samuel") suggested a reorganisation which would, in the words of the High Court "maintain...the benefits of the original proposal while including taxation or other financial benefits intended to counter the costs of the reorganisation."<sup>3</sup>

The proposed reorganisation had four aspects of which the financial arrangement, the subject of this case, was one.

The proposal was:

- (a) Myer was to remain as the parent and group holding company.
- (b) Myer Shopping Centres Ltd. was to own all real estate.
- (c) Myer Melbourne Ltd. would control and operate all retail trading outlets to eliminate some operating costs.

(d) The fourth aspect according to *Murphy J.* in the Supreme Court of Victoria was that a new company would be incorporated in Canberra to be called Myer Finance Limited. Myer Finance would control some or all of the financing of the group's operations.

The judges in the Full High Court described the fourth aspect as one where:

...Myer would enter into a financial arrangement with an organization whereby an income stream within the Myer group would be sold for a lump sum. It was intended that the transaction would be arranged in such a way that the income stream which was sold would provide to Myer a lump sum payment which would be a non-taxable capital receipt.<sup>4</sup>

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<sup>3</sup>87 A.T.C. 4363 at p. 4365.

<sup>4</sup>*Ibid.*, p. 4365.

The reason for the fourth aspect of the proposal was that at this time Myer had embarked on an intensive plan to diversify. As a result of its need for funds it had to resort to external sources for finance. The extent that Myer was permitted to borrow was however limited by the necessity to keep within the borrowing ratio as stipulated in its debenture trust deed.

Additionally as any borrowing was required to be disclosed, the interest on such borrowing would adversely impact on the published profit figures.

Myer owned shares in a number of subsidiaries which in turn owned a number of properties. These shares were worth approximately \$80,000,000. Myer sold these shares to Myer Shopping Centres Ltd.

As part of the reorganisation on 6 March 1981, Myer lent the \$80,000,000 to Myer Finance Ltd (originally called Margosa Ltd.) for a period of 7 1/4 years. Under the terms of the agreement, Myer Finance was to pay interest at 12 1/2% per annum to Myer. As one of the loan agreement clauses, Myer had the right during the term of the loan "...to sell, transfer or assign the Principal Amount and/or the interest payable or prepayable...provided that it shall give written notice of such sale, transfer or assignment to the Borrower".<sup>5</sup>

The Full High Court stated the next step in the transaction was:

On 9 March 1981, [three days after making the loan and following the receipt of a small amount of interest] Myer assigned to Citicorp Canberra Pty. Ltd ("Citicorp") 'absolutely the moneys due or to become due as the interest payments and interest thereon...pursuant to' the loan agreement.<sup>6</sup>

The sum of \$45,370,000 was paid on that day to Myer by Citicorp as consideration for the assignment of the future interest. The purchase price represented a commercial calculation of the present value of the future interest receipts (\$72,500,000) at a commercial discount rate of 16%. This discounting calculation yielded the figure paid of \$45,370,000.

Myer notified Myer Finance of the assignment. Myer Finance thereafter paid the interest due, pursuant to the assignment, to Citicorp. The principal however was

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<sup>5</sup>Ibid., p. 4364.

<sup>6</sup>Ibid., p. 4364.

not assigned. Myer remained entitled to be repaid the principal sum of \$80,000,000 on, but not before, 30 June 1988 (in accordance with the terms of the loan agreement).

If the commercial discount rate of 16% was used, the present value of the \$80,000,000 principal was \$34,630,000.<sup>7</sup>

Myer had not only obtained the working capital which it needed but had done so in a way that did not affect the borrowing ratio of its debenture trust deed.

In its review dated 28 August 1980, Hill Samuel Australia Ltd. stated the proposal at that time involved "a negative cost of financing." Hill Samuel stated that this negative cost of financing arose because, while the income stream that Myer assigned to Citicorp was approximately \$70,000,000, after tax Myer was foregoing income of only approximately \$38,000,000. In return for giving up this income over seven years Myer received an immediate lump sum cash payment of \$42,000,000 (subsequently increased). Not only did Myer receive a greater sum than it was to give up, it received that greater sum at a much earlier date. Hill Samuel estimated the net present value of this benefit and the interest saving involved, to be approximately \$9,000,000 after tax.

Citicorp was able to set off the interest payments received from Myer Finance against accumulated tax losses which it had available. This enabled Citicorp to purchase the income stream at the present value discount rate of 16% while not allowing for any discount for tax.

The Full High Court found:

Had it not been for the availability of the tax losses, the transaction would have had no attraction for Citicorp. The tax liability on the interest payments, in the absence of the tax losses, would have reduced the net worth of the future interest payments to an amount less than the amount of the consideration payable by Citicorp to Myer.

and

The loan would not have been given to Myer Finance if Citicorp had not been in a

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<sup>7</sup>Hill, *A Pre-Bicentennial Reminder of Our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 *Taxation in Australia*, No. 1, p. 12.

position to take the assignment of the right to interest.<sup>8</sup>

This was a critical finding to the ultimate result.

In its balance sheet as at 31 July 1981, Myer showed as a liability the following entry "Balance of proceeds from assignment of income \$41,480,833." In its Profit and Loss Statement Myer included an item "Amortisation of proceeds from assignment of income \$3,889,167". A copy of the Profit and Loss Statement and the Balance Sheet were appended to Myers return of income. Myer described the consideration received in a schedule to the accounts as being of a capital nature. On that basis the amortisation was excluded from the taxable income.

The Commissioner of Taxation assessed the whole sum of \$45,370,000 as income in the hands of Myer. The Commissioner asserted this on the basis that the receipt was:

(a) income according to ordinary concepts and therefore within section 25(1) of the Income Tax Assessment Act 1936 ("the Australian Act"). Section 25(1) provides the "assessable income of a taxpayer shall include...the gross income derived directly or indirectly from all sources whether in or out of Australia" in respect of an Australian resident and for a non-resident it includes "the gross income derived directly or indirectly from all sources in Australia". The New Zealand equivalent of section 25(1) of the Australian Act is section 65(2)(1) of the Income Tax Act 1976 or, alternatively;

(b) assessable income as a result of (the former) section 26(a). Section 25A(1) of the Australian Act which replaced section 26(a) provides:

The assessable income of a taxpayer shall include profit arising from the sale by the taxpayer of any property acquired by him for the purpose of profit-making by sale, or from the carrying on or carrying out of any profit-making undertaking or scheme.

Section 65(2)(e) of the Income Tax Act is the New Zealand equivalent to section 26(a).

The Commissioner also argued if neither of the above provisions applied, that section 260 (the New Zealand equivalent is section 99) of the Australian Act would render the receipt assessable income of the taxpayer and applied to annihilate the

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<sup>8</sup>*F.C. of T. v. The Myer Emporium Ltd.* 87 A.T.C. 4363 at p. 4365.

assignment to Citicorp. It was not submitted that the principal sum was other than a capital asset.

Myer objected to the Commissioner's assessment. The objection was disallowed so Myer appealed to the Supreme Court of Victoria.

(2) The Supreme Court of Victoria<sup>9</sup>

*Murphy J.* found that Myer had at all material times intended to assign the right to the future income stream arising from the loan for a lump sum. The motivating purpose of Myer in entering the arrangement was to obtain working capital in order for it to diversify, not to make a profit. His Honour therefore held that the lump sum was not income under former section 26(a).

The right to receive future interest payments as distinct from the actual payments themselves was a capital asset (a chose in action). The price that was received for the sale of that asset was of a capital nature. It was not assessable as income according to ordinary concepts. The assignment was not in the ordinary course of Myer's retailing business.

In addition section 260 of the Australian Act had no application.

(3) The Full Federal Court<sup>10</sup>

The Commissioner appealed against the decision of *Murphy J.* The appeal was heard in the Full Federal Court by *Fox, Lockhart and Jenkinson J.J.*

The appeal was dismissed. Their Honours held:

(a) The lump sum received by Myer for the sale of the right to receive interest payments was a capital amount. As also held by *Murphy J.* it was not assessable as income according to ordinary concepts. The assignment was not in the course of Myer's business and the asset that was sold was not part of Myer's stock-in-trade. The sum was not received in substitution of interest.

(b) The lump sum received was not assessable under the former section

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<sup>9</sup>*The Myer Emporium Ltd. v. F.C. of T.* 85 A.T.C. 4111.

<sup>10</sup>*F.C. of T. v. The Myer Emporium Ltd.* 85 A.T.C. 4601.

26(a). There was no profit element in the lump sum. *Fox J.* said the lump sum was made as "recompense for deprivation of the interest"<sup>11</sup> while *Lockhart J.* held the sum was "a capitalisation of its [Myer's] entitlement to interest".<sup>12</sup> In addition there was no profit-making undertaking or scheme connected with the receipt of the lump sum payment.

(c) Section 260 did not apply because no relevant alteration in the incidence of tax was involved in either the loan agreement or the assignment.

## 2. THE FULL HIGH COURT

The Commissioner appealed against the decision of the Full Federal Court. The appeal in the Full High Court was heard by *Mason A.C.J., Wilson, Brennan, Deane* and *Dawson J.J.* The decision was a joint decision. The High Court unanimously reversed the decision of the Full Federal Court allowing the appeal.

### (1) A Review of the Facts

Their Honours reviewed the facts of the case. In looking at the loan and the assignment the Court stated, as had the lower courts, that the assignment of the right to interest was an integral part of the reorganisation of the Myer group.

At the early stages of their judgment, in reviewing the facts of the case, their Honours noted:

(a) The assignment was part of the financial arrangement to replace the proposed property trust.

(b) No loan would have been made to Myer Finance if Citicorp had not been in a position to take the assignment of the right to interest:

Had it not been for the availability of the tax losses, the transaction would have had no attraction for Citicorp. The tax liability on the interest payments, in the absence of the tax losses, would have reduced the net worth of the future interest payments to an amount less than the amount of the consideration

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<sup>11</sup>Ibid., p. 4608.

<sup>12</sup>Ibid., p. 4611.

payable by Citicorp to Myer.<sup>13</sup>

Graham Hill<sup>14</sup> comments:

Save that these comments make clear that Citicorp may have paid more than market value for the income stream, it is hard to see that they have any juridicial relevance. The same result would presumably have come to pass if Citicorp had not had available losses to offset the income stream.

(c) All accounting and legal advice was given on the instrument on the basis that the assignment would occur after the loan.

(d) Minutes of Directors' meetings treated the loan and assignment as part of the financial arrangement involved in the reorganisation.

(e) The correspondence between Myer and the National Bank of Australasia Ltd proceeded on the basis that the assignment would follow the loan:

Mr Tope, a director of Myer, in his evidence agreed that apart from the initial interest payment of \$82,192 it was never intended that Myer receive any of the interest from the loan, because at the time Myer made the loan it intended and had arranged to sell the right to the interest.<sup>15</sup>

## (2) The First Strand of the Judgment

In looking at the nature of the income derived in a business, the High Court stopped short of agreeing with the Commissioner's contention that a gain made from a business deal or venture, in the nature of trade, by a taxpayer, will be income even if the transaction is outside the ordinary course of the business.

The High Court however went a considerable way in that direction in the following passage:

Although it is well settled that a profit or gain made in the ordinary course of carrying on a business constitutes income, it does not follow that a profit or gain made in a transaction entered into otherwise than in the ordinary course of carrying on the taxpayer's business is not income. Because a business is carried on with a view to profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income. But a gain made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or

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<sup>13</sup>87 A.T.C. 4363 at p. 4365.

<sup>14</sup>Hill, *A Pre-Bicentennial Reminder of Our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 Taxation in Australia, No. 1, p. 17.

<sup>15</sup>87 A.T.C. 4363 at p. 4365.

gain may well constitute income. Whether it does depends very much on the circumstances of the case. Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or a "one-off" transaction preclude it from being properly characterized as income (*F.C. of T. v. Whitfords Beach Pty. Ltd.* 82 ATC 4031 at pp. 4036-4037, 4042; (1982) 150 C.L.R. 355 at pp. 366-367, 376). The authorities establish that a profit or gain so made will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to the profit.<sup>16</sup> (emphasis added).

This passage has been quoted or referred to in many of the subsequent Australian decisions concerning the capital - income distinction.

The judges held that the \$45,370,000 was a profit derived from a transaction which, while it was not within the ordinary course of the taxpayer's business, it was entered into by the taxpayer with the intention or purpose of making a profit or gain, and the transaction was a commercial transaction. As a result the transaction produced income according to ordinary concepts.

It was emphasised both by *Murphy J.* in the Supreme Court of Victoria and the Full Federal Court that the assignment was outside the ordinary course of Myer's business of retailing. In his judgment *Murphy J.* cites *Van den Berghs v. Clark*.<sup>17</sup> In that case a large sum was paid in consideration of a company consenting to cancel several contracts. The lump sum was not a taxable profit or gain for income tax purposes. The contracts cancelled were not ordinary commercial contracts made in the course of carrying on the trading activities of the taxpayer. The contracts related to the taxpayer's profit-making structure and not the sale of the appellant's products.

(a) *Californian Copper*. Their Honours drew support for their decision from the celebrated case of *Californian Copper Syndicate v. Harris*.<sup>18</sup>

In this case the taxpayer company was incorporated on 5 February 1901 to acquire copper and other mines. A short time after the company acquired copper

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<sup>16</sup>Ibid., pp. 4366-4367.

<sup>17</sup>(1935) A.C. 431.

<sup>18</sup>(1904) 5 T.C. 159.



bearing land for 24,000 pounds. The remainder of the paid up capital of the company was employed in developing the mine. In April 1902 a portion of the land was sold. The balance of the land was disposed of in August 1904. The consideration for the transactions was 300,000 pounds in fully paid up shares in the purchaser company.

The Court of Exchequer (Scotland) held that the profit made on the land sales was assessable income because the taxpayer had never intended to work the property with a view to earning income from the mining operations on the property. The taxpayer company was authorised under its Articles of Association to enter into such transactions and it therefore fell within the business that it was empowered to carry on. The transaction was however an isolated transaction. Nevertheless the profit derived was income.

The Lord Justice Clerk, Lord *MacDonald*, stated the general principle as follows:

It is quite a well settled principle in dealing with questions of assessment of income tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D of the *Income Tax Act* of 1842 assessable to income tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. The simplest case is that of a person or association of persons buying and selling lands or securities speculatively, in order to make gain, dealing in such investments as a business, and thereby seeking to make profits. There are many companies which in their very inception are formed for such a purpose, and in these cases it is not doubtful that, where they make a gain by a realisation, the gain they make is liable to be assessed for income tax.

What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being - Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?<sup>19</sup>(emphasis added)

Their Honours in *Myer* quoted the underlined sentence.

Graham Hill comments concerning the sentence as follows:

One could have been forgiven for understanding that quotation as requiring that the particular scheme for profit making be able to be characterised as 'an

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<sup>19</sup>Ibid., pp. 165-166.

operation of business'. It is true that the sale of the mining property in the *Californian Copper Syndicate* case was an isolated transaction which produced an income profit but it was found as a fact to be 'an act done in what is truly the carrying on or carrying out of a business'.<sup>20</sup>

Graham Hill in that article believes that the position of *Myer* can be contrasted with *Californian Copper*. Myer had been the financier for the group. As part of the reorganisation, the financing activities were taken over by Myer Finance. Consequently, it could be argued that the loan was made by Myer in the course of its going out of the business of financing rather than in the course of that business.

The Court of Exchequer (Scotland) in *Californian Copper* concluded that:

- (i) The company was formed to acquire the mineral field;
- (ii) The company had no intention to work the copper field purchased;
- (iii) Its purpose in purchasing the land was to exploit the field by inducing others to purchase the land.

The principle in *Californian Copper* has been applied in New Zealand, see *C. of I.R. v. Auckland Savings Bank*.<sup>21</sup>

(b) Post-Californian Copper. The Full High Court stated the test in *Californian Copper* (emphasised in the earlier quote) was subsequently approved in the Privy Council decision of *C. of T. v. Melbourne Trust Ltd.*<sup>22</sup> and applied in the House of Lords decision of *Ducker v. Rees Roturbo Development Syndicate Ltd.*<sup>23</sup>

In *Ducker's* case a company was formed with the primary purpose of acquiring, developing and exploiting an invention involving a pump by granting manufacturing licences under patents. In the course of its business the company acquired additional patents in connection with the invention. While the main business of the company was the granting of manufacturing licences, it always contemplated the possibility that its interest in the foreign patents could be sold.

The receipts from the sale of the interest in the foreign patents were held to

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<sup>20</sup>Hill, *A Pre-Bicentennial Reminder of Our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 Taxation in Australia, No. 1, p. 15.

<sup>21</sup>(1971) N.Z.L.R. 569.

<sup>22</sup>(1924) A.C. 1001 at p. 1010.

<sup>23</sup>(1928) A.C. 132 at p. 140.

constitute income. Their Honours in *Myer* quoted Lord *Buckmaster* in *Ducker* who stated (at pp. 141-142) this was not "a mere accidental dealing with a particular class of property" but "was part of their business which, though not of necessity the line on which they desired their business most extensively to develop, was one which they were prepared to undertake".

(c) Proposition from *Californian Copper* and *Ducker*. Their Honours in *Myer* conclude:

The important proposition to be derived from *Californian Copper* and *Ducker* is that a receipt may constitute income, if it arises from an isolated business operation or commercial transaction entered into otherwise than in the ordinary course of the carrying on of the taxpayer's business, so long as the taxpayer entered into the transaction with the intention or purpose of making a relevant profit or gain from the transaction.<sup>24</sup>(emphasis added)

(d) *Californian Copper* - Application in Insurance and Banking Cases.

The clearest application of the principle enunciated in *Californian Copper*, before the *Myer* case at least, has been in relation to banks and insurance companies. For a discussion of the case in New Zealand see *State Insurance Ltd. v. C. of I.R.* <sup>25</sup> in the third part of this thesis.

It is now settled law that generally any profit made or loss incurred on the disposal of shares and other easily realisable securities, is taken into account in calculating the assessable income of a bank or insurance company. In such cases it is unnecessary to establish that the bank or insurance company carried on a business of dealing in such assets.

(e) *Californian Copper* - Application Extended. Following from the proposition derived from *Californian Copper* and *Ducker* quoted at (c), their Honours in *Myer* suggested several reasons why the courts had not accepted "...the simple proposition that the existence of an intention or purpose of making a profit or gain is enough in itself to stamp the receipt with the character of income."

The reasons given by the High Court in *Myer* for the lack of acceptance by

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<sup>24</sup>87 A.T.C. 4363 at 4367.

<sup>25</sup>(1990) 12 N.Z.T.C. 7035.

the Courts of the "simple proposition" were:

(i) The notion that the realisation of an asset was an item of capital and not income. As already stated the High Court did not recognise this proposition.

(ii) A concern by the courts that windfall gains and gains from games of chance would be items of income unless the concept of income, apart from income from investments and personal exertion, was limited to profits and gains arising from business transactions.

Arguably however if it is sufficient (and accepted) that a receipt will be characterised as income when there is the existence of a profit-making intention, windfall gains at least may still not be characterised as income because in respect of these gains generally there will not be that profit-making purpose or intention.

(iii) The notion that a gain arising from recurrent transactions is income, while a gain arising from an isolated transaction is capital. The court said this notion was related to the idea that the carrying on of a business involves a systematic series of recurrent acts or activities.

(f) Adventure in the Nature of Trade. The High Court looked at some of the English decisions on profits derived from isolated transactions.

Their Honours stated that in the United Kingdom, Schedule D of the *Income Tax Act 1918* (U.K.) reinforced the notions in (e). The Schedule appeared to confine the concept of income to, inter alia, profits or gains from any trade. "Trade" was defined to include every "manufacture, adventure or concern in the nature of trade".

Transactions made in the ordinary course of business were seen as a gain or profit from a "trade". The issue, when there was an isolated transaction, was - 'did the profit arise from a concern in the nature of trade?' This gave rise to the notion of "adventure in the nature trade".

There has been a number of cases where the definition of trade has resulted in profits from isolated transactions being taxable under the above provision.

Their Honours in *Myer* contrasted two English cases, *Jones v. Leeming*<sup>26</sup> and

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<sup>26</sup>(1930) A.C. 415.

*Edwards (Inspector of Taxes) v. Bairstow*<sup>27</sup>.

Their Honours in *Myer* stated the conclusion in the House of Lords decision of *Jones v. Leeming* to be "...that a profit on an isolated sale, not being an adventure in the nature of trade, was a capital accretion (at p. 430)." <sup>28</sup> A central part of the House of Lords reasoning was that to constitute a trading or business transaction there needed to be an element of repetition or recurrence. The intention or purpose to make a profit or gain itself was not enough.

On the other hand in *Edwards (Inspector of Taxes) v. Bairstow*, joint venturers engaging in an isolated transaction of buying and selling a spinning plant, were liable to income tax on the profit from the resale. The buying and selling was made with a view to making a profit. The joint venturers had planned to sell the machinery even before they purchased it. They had no intention of using the plant and therefore did not purchase the machinery to employ it as an income-producing asset, or to consume or use it for enjoyment. Accordingly there was a profit from an adventure in the nature of trade.

Lord *Radcliffe* rejected the argument that because the profit arose from an isolated transaction it was not income and observed (at p 38), quoted by the Full High Court in *Myer*:

...that circumstance does not prevent a transaction which bears the badges of trade from being in truth an adventure in the nature of trade. The true question in such cases is whether the operations constitute an adventure of that kind, not whether they by themselves or they in conjunction with other operations, constitute the operator a person who carries on a trade. Dealing is, I think, essentially a trading adventure, and the respondents' operations were nothing but a deal or deals in plant and machinery. <sup>29</sup> (emphasis added)

The High Court noted some of the English judgments reflected the language of United Kingdom provisions which have no precise Australian counterpart. However they noted Privy Council and Australian decisions accepting that profits derived from a business operation or commercial transaction carrying out a profit-

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<sup>27</sup>(1956) A.C. 14.

<sup>28</sup>87 A.T.C. 4363 at p. 4368.

<sup>29</sup>*Ibid.*, p. 4368.

making scheme are income, while the proceeds of a mere realisation or change of investment, or from an enhancement of capital, are not income.<sup>30</sup>

Their Honours did not go on to discuss any other English decisions in this area.

(g) The Badges of Trade - What are They? In the passage quoted from *Edwards (Inspector of Taxes) v. Bairstow*, Lord Radcliffe referred to the "badges of trade".

Eight badges of trade have been identified.<sup>31</sup> They are:

- (i) The subject matter of the realisation;
- (ii) The length of the period of ownership;
- (iii) Frequency or number of similar transactions by the individual;
- (iv) Supplementary work on the property realised or in connection with the property realised;
- (v) The circumstances that are responsible for the realisation;
- (vi) The motive of the individual;
- (vii) Sustained activity by the individual;
- (viii) The personality of the taxpayer.

From both a New Zealand and Australian viewpoint, the English decisions in this area should be treated with caution as there is no equivalent extending definition of trade or business in either country.

A further caution in respect of the meaning of trade is given by Parsons<sup>32</sup> in his book *Income Taxation in Australia* concerning the United Kingdom law. He states:

Any attempt to state the United Kingdom law on the meaning of trade in the context of an isolated venture is fraught with difficulties. Authorities seem to go in pairs, the one appearing to stand for some proposition, the other contradicting that proposition. The explanation of the seeming contradictions, we are told, is that the United Kingdom regards the existence of a trade in a particular case as

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<sup>30</sup>*Ruhamah Property Co. Ltd. v. F.C. of T.* (1928) 41 C.L.R. 148 at pp. 151-152, 154; *McClelland v F.C. of T.* 70 A.T.C. 4115 at pp. 4120-4121; *London Australia Investment Co. Ltd. v F.C. of T.* 77 A.T.C. 4398 at pp. 4402-4403; and *F.C. of T. v. Whitfords Beach Pty. Ltd.* (1982) 150 C.L.R. 355.

<sup>31</sup>Alston, *Isolated Transactions and the Badges of Trade*, (1983) 28 Current Taxation 1-4 and 27-30.

<sup>32</sup>Parsons, *Income Taxation in Australia*, p. 161.

a question of fact, and it follows from the United Kingdom system of appeals that a court, which must find an error of law, cannot upset the finding of the Commissioners, save where the only reasonable conclusion on the basis of the stated case contradicts the conclusion of the Commissioners.

Given these cautionary notes it is somewhat surprising that the High Court in the *Myer* case made reference to and placed the reliance that it did on the concept of an adventure in the nature of trade.

Among the cases referred to by the High Court in this area was the Australian decision of *F.C. of T. v. Whitfords Beach Pty. Ltd.*<sup>33</sup> In that case *Mason J.* in respect of the United Kingdom legislation stated (at p. 371): "The authorities, and there are many of them, need to be read with a close eye to the differences between the Australian and the United Kingdom legislation".

(h) Myer and the Eight Criteria. In this section I measure the loan transaction and assignment (taken together) in *Myer* against the eight 'badges' of trade to see what, if any, conclusions can be drawn either about the badges of trade themselves, or the nature of the transactions in *Myer*.

(i) The Subject Matter of the Realisation. The character of the property that is purchased and sold may indicate the nature of the activity of the individual. Certain forms of property are more suggestive of trade than others, especially where the owner does not derive income or enjoyment from the property. An example is *I.R.C. v. Fraser*<sup>34</sup> where a large quantity of whisky purchased by the taxpayer and subsequently resold amounted to an adventure in the nature of trade.

Where the property acquired is of an investment type such as shares and land, it is less likely that its purchase and sale will be in the nature of trade. An example is *C. of I.R. v. Reinhold*<sup>35</sup> where four houses were purchased to resell (and subsequently were sold at a profit). The transaction was not an adventure in the nature of trade as the property was a form of investment that was capable of producing income.

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<sup>33</sup>(1982) 150 C.L.R. 355.

<sup>34</sup>(1942) 24 T.C. 498.

<sup>35</sup>(1953) 34 T.C. 389.

In *Myer*, the loan transaction and assignment taken together or individually, were capable of producing income and arguably were an investment-type of transaction. Accordingly on the basis of this badge it is unlikely that the transactions were in the nature of *Myer*'s trade.

This badge has been considered in a number of cases to be a strong indicator.

(ii) The Length of the Period of Ownership. In *Eames v. Stepwell Properties Ltd.*<sup>36</sup> Buckley J. stated:

...one element at least of investment must be that the acquirer of the investment intends to hold it, at any rate for some time, with a view to obtaining either some benefit in the way of income in the meantime or obtaining some profit, but not an immediate profit by resale.

Other cases have pointed out that this is not a particularly strong indicator: see for example, *Cross J. in Turner v. Last*.<sup>37</sup>

Viewing the transactions in *Myer* individually, the loan was for eight years indicating the purpose of investment. The right to future interest however was assigned within three days after the loan transaction was made, indicating the purpose of trade. This indicator is not therefore conclusive.

(iii) Frequency or Number of Similiar Transactions by the Individual. This indicator is akin to a test for the deductibility of expenditure. Dealing may be indicated where an individual undertakes similiar transactions either together or over a period.

Obviously *Myer* had at various times lent money to members of the group. However this was apparently the first time that *Myer* had ever assigned the right to income on a loan. When the loan transaction and assignment in *Myer* are taken together arguably this indicator does not point to an adventure in the nature of the trade.

(iv) Supplementary Work on the Property Realised or in Connection with the Property Realised. This indicator is best illustrated by *I.R.C. v.*

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<sup>36</sup>(1966) 43 T.C. 678 at p. 692.

<sup>37</sup>(1965) 42 T.C. 517.



*Livingston*<sup>38</sup> where three taxpayers purchased a cargo vessel. After extensive reconstruction and work on the vessel, it was sold as a steam drifter some months later. The profit was taxable, arising not only from an appreciation in capital but expenditure to make the boat marketable at a profit.

It has been suggested, while this was a single transaction, there were a number of smaller connected transactions that were part of the conversion of the vessel.

This badge has little application to the transactions in *Myer*. In the case of a loan there is little work one can do to make it 'more marketable'.

(v) The Circumstances that are Responsible for the Realisation. This factor can often negate suggestions that an individual is engaged in trade. In *West v. Phillips*<sup>39</sup> the taxpayer was able to show the sale of rental properties was because of rent control, the cost of maintaining the houses and increased taxation which made the houses unprofitable for investment purposes.

Focusing on the assignment in *Myer* as the 'realisation', as the lower courts found, the assignment arguably was made, primarily to obtain working capital. This factor would therefore negate the payment to Myer being assessable.

(vi) The Motive of the Individual. The English cases place much weight on the motive of the taxpayer. The courts appear to place more weight on imputed motive rather than actual motive.

In *I.R.C. v. Reinhold* it was held that the taxpayer had not engaged in "an adventure in the nature of trade." It was said that while a stated intention may be evidence of trade, there are other factors to take into account - especially the nature of the commodity. It was stated: "If...the subject of the transaction is normally used for investment - land, houses, stocks and shares - the inference is not so readily to be drawn from an admitted intention ..."

The stated intention of Myer in the loan and the assignment transactions as found by the lower courts, was to obtain working capital. The subject matter,

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<sup>38</sup>(1927) 11 T.C. 538.

<sup>39</sup>(1958) 38 T.C. 303.

whether the loan itself or lump sum produced from the assignment was used for investment. These factors would indicate there was no adventure in the nature of trade.

(vii) Sustained Activity by the Individual. A sustained activity by the taxpayer can be a strong indicator of trade. This badge incorporates the third and fourth criterion above.

There was no such sustained activity conducted by Myer in respect of the loan and assignment.

(viii) The Personality of the Taxpayer. A company, as against a person, is more likely to be carrying on a trade or business. Similarly a person or company is more likely to be carrying on a trade (in that transaction) if the transaction in question was in line with that person or company's usual trade.

Myer had acted as group financier but never before had it assigned the future right to income, its 'line of business' being of a retailer and property holder.

#### Conclusion.

Rather than supporting the decision that their Honours in *Myer* reached, an analysis of the badges would tend to indicate the transactions concerned did not amount to "an adventure in the nature of trade".

In applying the badges it is important to reiterate that they are only indicators. A. Alston<sup>40</sup> points out some of the tests are vague, and two or more badges may contradict each other. According to Alston the least useful of the badges is the sixth, that of motive. "As it is usually inferred from existing circumstances, one of the other badges must be present before it can be taken into account."<sup>41</sup>

I.C.F. Spry<sup>42</sup> also states that it is an "interesting but difficult question to what extent English authorities as to profits from adventures in the nature of trade are applicable in Australia."

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<sup>40</sup>Alston, *Isolated Transactions and the Badges of Trade*, (1983) 28 Current Taxation p. 28.

<sup>41</sup>*Ibid.*, p. 29.

<sup>42</sup>Spry, *The Implications of the Myer Emporium Case*, (1987) 15-16 Australian Tax Review, p. 155.

(i) The Profit-making Purpose. Their Honours stated a profit or gain from a transaction will be assessable as income where the taxpayer has entered into the transaction with a profit-making purpose. In the case of "a gain made in the ordinary course of carrying on the business", the gain is "invested with the profit-making purpose".

In respect of a transaction which is extraordinary, the taxpayer's intention or purpose in entering the transaction is inferred from the circumstances. The High Court does not discuss whether a profit or gain from an extraordinary transaction will be assessable where the profit-making purpose was one of a number of purposes of the taxpayer in entering into the transaction.

The High Court did not reject the finding of *Murphy J.* (in the Supreme Court of Victoria) that Myer had a purpose in entering the transaction to raise working capital. Accordingly it would appear that their Honours accepted that Myer had more than one purpose. Their Honours noted *Murphy J.*'s finding as to purpose at p. 4365-6.

In advancing the proposition in respect of the need for a profit-making purpose, the High Court cite *Edwards (Inspector of Taxes) v. Bairstow*. Rankin and Taylor<sup>43</sup> submit that decision may not be authority for the proposition in the *Myer* case. As stated the *Edwards* case concerned joint venturers who were engaged in an isolated transaction, buying and selling a complete spinning plant. They engaged in the transaction intending to make a profit, having no intention of using it. They were held liable to income tax on the profit made on resale. The sole purpose of the acquisition was a profitable resale.

The case established that if an asset is acquired for the purpose of resale, any profit or gain on sale will be assessable. The authors believe however that *Edwards* case is not authority for the broader proposition of where there is more than one purpose, and one of those purposes is that of profit-making, any profit or gain from such a sale will be assessable. Accordingly they believe the decision does not appear to support the actual decision in *Myer* on the basis that Myer arguably had more than

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<sup>43</sup>Taylor and Rankin, *The Myer Case and the Taxation of Gains in 1988*, 11 The Sydney Law Review p. 625.

one purpose in entering the transactions in question.

The writers mention the Canadian Case of *Norton Investments v. R.*<sup>44</sup> not cited by the High Court. The case is authority for the situation where an intention of resale is equally dominant with another purpose. Such an intention is sufficient to bring profits into the category of income. Taylor and Rankin believe this case better supports the decision in *Myer* and would have substantiated the High Court's reasoning in *Myer*.

In New Zealand under section 65(2)(e), for the application of the second and third limbs, where there is more than one purpose, the dominant purpose of the taxpayer is important.

As already noted *Mason J.* in *F.C. of T. v. Whitfords Beach Pty. Ltd.*<sup>45</sup> stated: "The [United Kingdom] authorities, and there are many of them, need to be read with a close eye to the differences between the Australian and the United Kingdom legislation". Taylor and Rankin question whether this was done in the *Myer* case as their Honours placed reliance upon the dicta of Lord *Radcliffe* in *Edwards*, dicta made in the context of a United Kingdom provision for which there is no equivalent in Australia or New Zealand and which related to the concept of 'an adventure in the nature of trade'. Accordingly *Edwards v. Bairstow* may not be good authority for the first proposition in *Myer*.

(j) A Mere Realisation or Change in Investment. The High Court said that the proposition that 'a mere realisation or change in investment' is not income required some elaboration. To recapitulate, in *Californian Copper*<sup>46</sup> the Lord Justice Clerk referred to the distinction between a gain being "a mere enhancement of value by realising a security" and "a gain made in an operation of business in carrying out a scheme for profit-making".

Their Honours in *Myer* stated:<sup>47</sup>

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<sup>44</sup>78 D.T.C. 6078.

<sup>45</sup>(1982) 150 C.L.R. 355.

<sup>46</sup>(1904) 5 T.C. 159 at p. 166.

<sup>47</sup>87 A.T.C. 4363 at p. 4368.

(i) "...the emphasis is on the adjective 'mere' (per *Whitfords Beach*, at A.T.C. pp. 4046-4047...)". The High Court in *Myer* did not however elaborate on what is meant by 'mere'.

Parsons<sup>48</sup> states that the basis of the distinction between circumstances which are a "mere" advantageous realisation and those that constitute an advantageous realisation amounting to a trade is not evident from the cases. The "mere" advantageous realisation may, he suggests, "...be concerned to express the lack of a sufficient demonstration of system and organisation in the circumstances to make them a trade."

Concerning *Whitfords Beach*, Parsons states:

In the result the case does not assist in determining the degree of system and organisation that will take circumstances out of the mere advantageous realisation notion...If there had been no change in shareholding in *Whitfords Beach*, and the old shareholders had moved the company to undertake the development, the circumstances would presumably have been held by all judges to be a mere advantageous realisation.<sup>49</sup>

(ii) If the investments were initially acquired as part of a business with the intention or purpose that at a subsequent date they would be realised in order to make a profit arising from their increase in value, profits made from such a change in investment or realisation may constitute income.

The Court continued by stating the converse - if at the time of acquisition, there was no intention or purpose of profit-making by sale, when the decision to sell is made, the profit is capital, because the proceeds were from a "mere" realisation (providing the asset would not be a revenue asset on other grounds.)

But it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction.<sup>50</sup>

In *Myer* therefore if the assignment to Citicorp had been unrelated to and independent of the decision to enter the loan agreement (i.e., there had been no

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<sup>48</sup>Parsons, *Income Taxation In Australia*, p. 163.

<sup>49</sup>*Ibid.*, p. 164.

<sup>50</sup>87 A.T.C. 4363 at p. 4369

intention or profit-making purpose when the loan agreement was entered into), then the argument that the assignment was "no more than the realization of a capital asset would perhaps have had more force...". However, even in such a situation, their Honours stated the taxpayer's argument would not have prevailed.

The Court distinguished the decision of *I.R. Commrs. v. Paget*<sup>51</sup> on this point. Miss Paget was the owner of bearer bonds issued by the City of Budapest and the Kingdom of Yugoslavia. She sold interest coupons attached to the foreign bearer bonds to dealers in those coupons. The sale price received was held not to be "income arising from securities out of the United Kingdom" and therefore income within the United Kingdom tax legislation. No interest payments were made on the bonds as the issuers had defaulted in due performance of their obligations. Had they been made, the interest payments would have been assessable income. Miss Paget did not initially acquire the bond coupons with the intention or purpose of selling the right to interest on the coupons. The Court of Appeal held that the proceeds from the coupon sales were capital.

Their Honour's in *Myer* stated that neither *Paget* nor the discussion of *Dixon* and *Evatt J.J.* in *C. of T. (Vic) v. Phillips*<sup>52</sup> was decisive.

*Myer* had strongly relied on the statement made by *Dixon* and *Evatt J.J.* in *Phillips'* case that:

It is true that to treat a sum of money as income because it is computed or measured by reference to loss of future income is an erroneous method of reasoning... It is erroneous because, for example, the right to future income may be an asset of a capital nature and the sum measured by reference to the loss of the future income may be a capital payment made to replace that right...<sup>53</sup>

The High Court in *Myer* said the transaction in *Phillips'* case was of a different kind from that involved in *Myer*. As in *Paget*, there was no question of a profit-making scheme. *Phillips'* case concerned payments made to the governing director of a company as compensation for the termination of his employment. The

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<sup>51</sup>(1938) K.B. 25.

<sup>52</sup>(1936) 55 C.L.R. 144.

<sup>53</sup>*Ibid.*, p. 146.

payments calculated on a percentage of the future net profits of the company were held to be of an income nature.

The High Court also stated there are many examples where the sale of a capital asset produces an income receipt, generally where the receipt is paid on a periodic, regular or recurrent basis. These characteristics being characteristics of income.

(k) Periodicity, Regularity and Recurrence. The Court noted that the "periodicity, regularity and recurrence of a receipt has been considered to be a hallmark of its character as income in accordance with the ordinary concepts and usages of mankind". In addition the need to distinguish between capital and income for trust and other purposes has focused attention on the difference between the right to receive future income and the actual receipt of that income. This difference has given rise to the analogical difference between the fruit and the tree. Their Honours recognised the value of these considerations in distinguishing between income and capital "in conventional situations". It is unclear what a conventional situation is. It may be implied that *Myer* is therefore "unconventional" on the facts.

Their Honours however downplay the importance of these considerations:

...their significance is diminished when the receipt in question is generated in the course of carrying on a business, especially if it should transpire that the receipt is generated as a profit component of a profit-making scheme. If the profit be made in the course of carrying on a business that in itself is a fact of telling significance. It does not detract from its significance that the particular transaction is unusual or extraordinary, judged by reference to the transactions in which the taxpayer usually engages, if it be entered into in the course of carrying on the taxpayer's business. And, if it appears that there is a specific profit-making scheme, it is pointless to say that it is unusual or extraordinary in the sense discussed.<sup>54</sup> (emphasis added)

The Court make it clear from the underlined statements that it is not just receipts from transactions in the 'ordinary course of carrying on a business' that can constitute income but receipts from unusual or extraordinary transactions can also constitute income. This is an expansion of the concept of income. Ultimately most receipts are generated in the course of carrying on a business. If, based on their

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<sup>54</sup>87 A.T.C. 4363 at p. 4370.

Honours' statements, this is the criterion for determining whether a receipt is income then, as was stated in *F.C. of T. v. Spedley Securities Ltd.*,<sup>55</sup> most transactions will be caught whether of a capital or revenue nature.

Their Honours' in *Myer* apply their comments to Myer:

- (i) Its business was that of a retailer and property developer.
- (ii) It had carried on business of financier to the Myer group prior to the acquisition of Myer Finance.
- (iii) The loan and assignment was entered into by Myer in the course of its business.
- (iv) The transactions, especially the assignment, were 'novel'. Myer had never entered into such an arrangement before. That however, their Honours said, did not take the transactions "out of the course of the carrying on of Myer's profit-making business."<sup>56</sup>

Their Honours further stated that the transactions or the assignment on its own could not be "the mere realization of a capital asset... the assignment was not unrelated to and independent of the loan agreement". The loan agreement and assignment:

...were interdependent in the sense that Myer would not have entered into the loan agreement unless it knew that Citicorp would shortly thereafter take an assignment of the moneys due or to become due for a sum approximating the amount payable in consideration of the assignment.<sup>57</sup>

As such, the Court found that the two transactions from Myer's viewpoint were essential and integral elements in a profit-making scheme. The lower courts had found that the transactions together were essential, however the purpose of the transactions was to obtain working capital.

(1) Was there a "Profit"? Their Honours in *Myer* commented that if the loan agreement and the assignment were viewed as being separate and independent

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<sup>55</sup>88 A.T.C. 4126.

<sup>56</sup>87 A.T.C. 4363 at p. 4370.

<sup>57</sup>*Ibid.*, 4370.



transactions, the argument put forward by Myer that no relevant profit was derived from the assignment was compelling.

As Graham Hill points out:

None of the judges in the courts below had been able to discern the existence of any profit to Myer. This was because in analysing the transaction they had looked solely at the transaction of sale between Myer and Citicorp. Under that transaction Myer sold an asset worth, let it be assumed \$45,370,000 and received in payment for it an amount equivalent to the value.<sup>58</sup>

He points out that, while apparently no valuation was requested, the worth of the income stream (\$45,370,000) might have been seriously disputed. A willing, but not too willing (or eager) purchaser may not have agreed to purchase the income stream from Myer without taking the tax consequences into consideration. (Indeed it is extremely unlikely that any purchaser other than one with tax losses, would have ignored the tax consequences).

Citicorp was an arm's length purchaser and as such the price it was prepared to pay for the asset generally would be the best evidence of the actual value of the asset. However Hill suggests that it is "unreal" to say in the present situation that the hypothetical willing purchaser would pay an amount that ignored tax. As a result of the tax consequences and the lack of "willing" purchasers, the income stream may have been overvalued.

Even looking at the loan transaction and the assignment together it is difficult to discern a profit. Graham Hill comments Myer lent \$80,000,000 to Myer Finance. Interest payments under the loan amounted to \$72,500,000 (excluding the \$82,192 payment made prior to the assignment) over the period of the loan. Myer assigned the right to the future income for \$45,370,000, being the present value of the \$72,500,000 interest stream discounted at 16%. The right to the repayment of the principal was worth, in present value terms \$34,630,000. If the \$82,192 interest paid by Myer Finance to Myer before the assignment is excluded, the right to future income and the right to the principal repayment total \$80,000,000 which is exactly the value of the assets held by Myer prior to the assignment.

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<sup>58</sup>Hill, *A Pre-Bicentennial Reminder of Our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 Taxation in Australia, No. 1, p. 13.

Mr Hill<sup>59</sup> states that this type of analysis suggested an analogy to the decision in *C. of T. v. Becker*.<sup>60</sup>

In that case the taxpayer had a capital asset in the form of land which was worth 12,000 pounds at the outset of the arrangement. National Security regulations prevented the sale of land at a price much in excess of the value the land had on a certain date. Becker therefore adopted a scheme whereby the land was transferred for 8,000 pounds pursuant to a contract whereby the 8,000 pounds was applied to the issue of 8000 fully paid shares issued by the purchaser company. The shares were subsequently sold in an arms length transaction for 12,000 pounds.

*Kitto J.* stated that the purpose of the steps taken by the taxpayer was to obtain the full value for the land. There was no element of profit assessable and section 26(a) did not apply.

*Fullagar J.* said: "A profit can only be ascertained by comparing one sum of money with another."

The High Court in *Myer* accepted that no profit arose from the sale of the right to income where the "consideration payable for the assignment reflected the true value of the" assigned chose in action. It was however in the larger transaction that the High Court found a relevant profit, the amount payable on the assignment.

The Court stated:<sup>61</sup>

But once the two transactions are seen as integral elements in one profit-making scheme, it is apparent that Myer made a relevant profit, that profit being the amount payable on the assignment. As a result of the two transactions Myer, having lent \$80,000,000 on 6 March 1981 repayable in accordance with the terms of the loan agreement, had profited by 9 March 1981 to the extent of the first interest payment received on 6 March 1981 and the sum of \$45,370,000 paid for the assignment, the principal on the loan being intact. Of course the value of the chose in action, the right to recover the principal sum, was substantially less than the amount of the principal sum because there was no obligation to repay until 30 June 1988. But this circumstance cannot affect the character of the consideration for the assignment. It exists in every case where money is lent for a fixed term.(emphasis added)

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<sup>59</sup>*Ibid.*, p. 14.

<sup>60</sup>(1952) 87 C.L.R. 456.

<sup>61</sup>87 A.T.C. 4363 at p. 4370.

Spry comments:

It was however not to the point that in the case of all loans a division into capital and interest components may be made. What was to the point was that in the present case it was being contended that Myer had obtained a profit of \$45,370,000 on 9th March 1981, despite arguments that no real or commercial profit had arisen.<sup>62</sup>

Myer assigned the right to future income. This is a chose in action. In the above paragraph their Honours refer to "...the value of the chose in action, the right to recover the principal sum..." The chose in action did not consist in the right to recover the principal sum. The principal sum was not assigned. Myer throughout the term of the loan was always entitled to repayment at the end of the term of the loan. At no time was this assigned. The right to the future income was assigned. This gave Citicorp, the assignee, the right to recover the income, not the principal. The value of the chose was therefore the right to recover the interest.

The Court seems to have held the view that it would be wrong to take into account any other value of the chose in action at the end of the 7 1/4 years than the full \$80,000,000 value of the loan. Graham Hill<sup>63</sup> comments that it is not clear if evidence of the present value of the loan was presented but in any event the Court would not have seen such evidence as relevant.

(m) The Accounting Approach. The High Court went on to justify its conclusion (that a profit had arisen) by the accounting basis employed in calculating profit and losses for the purposes of the Australian Act. The profits were calculated upon an historical cost basis and not economic equivalence. According to historical cost, where money is lent for a term, at interest, the debt to the lender is brought to account at the same value as the loan. The amount of the debt does not reduce because the lender does not have the use and enjoyment of the money lent for the term of the loan.

While this is correct for accounting purposes, it should be noted that the value of the debt in the lender's books may reduce due to extraordinary

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<sup>62</sup>Spry, *The Implications of the Myer Emporium Case*, (1987) 15-16 Australian Tax Review, p. 155.

<sup>63</sup>Hill, *A Pre-Bicentennial Reminder of Our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 Taxation in Australia, No. 1, p. 14.

circumstances. For example, if the borrower was unable to pay his or her debts in full, the debt would be reduced to the amount of the expected pay-out (if any) with the balance written off.

Graham Hill<sup>64</sup> suggests the High Court was saying that the loan would be treated in the books at par, with the interest stream having no separate value. Consequently, when the income stream alone is sold, the whole of the sale price is profit.

The Court looked at the treatment of such a debt if economic equivalence were the appropriate accounting basis. The debt would initially be brought into the accounts at a figure less than the amount of the money lent, while at the corresponding time the right to interest on that would be accounted for at the maximum figure. The amount of debt would increase day by day until at the expiration of the term the amount of the debt would reflect the amount of the money originally lent. The right to interest however would reduce until a nil figure at the expiration of the term. At any point during the term of the loan the Court said the aggregate of the debt and the right to interest would equal the amount of money lent (assuming the same discount rates are used).

Looking at the accounting treatment (historical cost) of such a loan, their Honour's stated:<sup>65</sup>

(i) The debt owed by the borrower is brought to account at the same figure as the money lent.

(ii) The right to interest does not appear in either the lender's Balance Sheet or Profit and Loss Account, "...the right to interest on the money lent is not treated as an asset at all."

(iii) No distinction is made between the interest itself and the right to that interest. The right to the interest can not be treated as an additional asset.

Effectively the Court was saying, for making a loan of \$80,000,000 Myer

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<sup>64</sup>Hill, *A Pre-Bicentennial Reminder of Our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 Taxation in Australia, No. 1, p. 14.

<sup>65</sup>87 A.T.C. 4363 at p. 4371.

acquired a corresponding debt of \$80,000,000. It received from Citicorp the sum of \$45,370,000 in cash. Thus a profit of \$45,370,000 had been made.

Graham Hill points out:

What a business man would no doubt have concluded would be that Myer ultimately but progressively over the term of the loan to June 1988 made a profit as the time approached for repayment of the principal sum so that as the present discounted value of the principal sum increased there was a profit which was finally and irrevocably made when the principal sum of \$80,000,000 was repaid on 30 June 1988.<sup>66</sup>

If the loan had been for precisely seven years, each year Myer would have derived a seventh of the difference between the figure paid by Citicorp and the principal loan sum. By 30 June 1988 the whole of the difference would be derived. Any doubts over the ability of Myer Finance to repay the principal sum would be reflected in the accounting treatment which could defer the derivation of the profit until the time for payment arrived.

It is arguable in line with Graham Hill's comments above, if there was a profit, it should have been recognised over the term of the loan to which it related. If the interest on the loan had been paid in one lump sum at the beginning of the loan period, there would be a strong argument based on the accounting principle of matching, for recognising the lump sum interest payment over the period to which it related that is, the seven years.

Accordingly, if the effect of the lump sum paid on the assignment of the right to the income is to convert future income into present income the income should be recognised over the term of the loan.

The writers in "*The Myer Case and the Taxation of Gains in 1988*"<sup>67</sup> believe that there is another possible interpretation of the historical cost principles. This is that the loan and the right to interest should both be treated as separate assets and each brought into account at their cost. Without having a purchase price, the best evidence of the cost they suggest:

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<sup>66</sup>Hill, *A Pre-Bicentennial Reminder of Our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 *Taxation in Australia*, No. 1, p. 14.

<sup>67</sup>Taylor and Rankin, *The Myer Case and the Taxation of Gains in 1988*, 11 *The Sydney Law Review* p. 625.

...would seem to be the market value at the time of acquisition. This interpretation may be adopted by the courts if the right to interest and the right to repayment of principal are sold as separate assets with separate prices. This interpretation of historical cost principles is similar to the principles of economic equivalence in that assets are brought into account at market value. As a result, in the context of the facts of the *Myer Case*, the consideration received on the assignment of the right to interest is not a profit. This interpretation of historical cost principles is different to the principles of economic equivalence in that the right to repayment of principal is not revalued each year at market value but remains in the accounts at historical cost. The effect of this difference is that a profit only arises in relation to the right to repayment of principal when it becomes due and Myer is entitled to \$80m. in repayment.<sup>68</sup>

Their Honours in *Myer* continued: "The making of a loan does not immediately produce a capital gain equal to the present value of the interest to be paid."

I believe that it is incorrect to state that the loan produced the capital gain. The loan was made. Subsequently the interest on the loan was assigned. The assignment 'produced' the gain not the loan itself. It is true that if there had been no loan, no assignment would have been possible. However a loan will produce periodic income in the form of interest, while an assignment of the right to such income (a chose in action) produces a different type of receipt, which is generally in a lump sum.

The Court stated:

The right to interest is not a capital asset which is progressively transformed into income as and when the interest is received.

That is not to say that a right to interest is not an existing chose in action...But the interest which becomes due is not the produce of the mere contractual right to interest severed from the debt for the money lent. Interest is regarded as flowing from the principal sum and to be compensation to the lender for being kept out of the use and enjoyment of the principal sum. A covenant to pay interest on a principal sum may, according to the terms of the lending agreement, be independent of or accessory to a covenant to repay the principal sum or the covenants may be integral parts of a single obligation, but it is of the essence of interest that it is referable to a principal sum. The source of interest is never the mere covenant to pay.<sup>69</sup>

The Court went on to distinguish interest from an annuity. Annuity payments, in contrast, are derived solely from the annuity contract, not from the money paid for the annuity. When a contractual right to be paid an annuity (a

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<sup>68</sup>Ibid., p. 625.

<sup>69</sup>87 A.T.C. 4363 at p. 4371.

capital asset) is sold, the proceeds in the hands of the vendor are ordinarily capital because there is the sale of a capital asset. *Paget*<sup>70</sup> was used as support for this proposition.

Their Honours stated (at p. 4371), if a lender who was selling a right to interest severed from the debt, could be regarded as selling an income-producing right, *Paget's* case indicates that, the price received should be a capital item (receipt). "But the contractual right [to interest] is not the source of the interest to which it relates: a contractual right severed from the debt is not the structure which produces that income."

*Paget* therefore did not apply because, on the Court's reasoning, unlike *Paget* no income producing right (to interest) had been sold. The assignment to the right to interest did not itself produce the income.

This approach can be contrasted with the lower courts. In the Federal Court *Fox J.* stated:<sup>71</sup> "That such an assignment [of a right to future interest], for a lump sum, is in general productive of a non-income receipt is in accordance with principle, as illustrated by many cases."

While it may be true that for accounting purposes in a normal loan transaction the right to interest is not distinguished from the interest income; and, interest flows are distinguished from the principal sum not the right to interest, the present case is not the usual type of loan transaction. The right to income has been assigned. As the assignee Citicorp will receive interest payments from Myer Finance totalling \$72,500,000. The right to interest is severed from the principal. Myer is entitled to repayment of the principal while Citicorp, the interest on the loan. As far as Citicorp is concerned the interest received from Myer Finance is the product of the assignment. Citicorp does not receive income by virtue of the loan from Myer to Myer Finance but by virtue of the assignment. In practical terms the source of the interest is the assignment. This view is supported by the legal position. Citicorp was now the recipient of the income pursuant to the assignment. Citicorp's rights to sue for non-

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<sup>70</sup>(1938) 2 K.B. 25 at pp. 35, 44-45.

<sup>71</sup>85 A.T.C. 4601 at p. 4606.

payment of interest lie in the assignment documents.

It may therefore be incorrect to state "...a contractual right severed from the debt is not the structure which produces that income."

### (3) The Second Strand of the Judgment

Their Honours went on to state what is now known as the second strand of the judgment. If a "lender sells his mere right to interest for a lump sum, the lump sum is received in exchange for, and ordinarily as the present value of, the future interest which he [the taxpayer] would have received".<sup>72</sup> This receipt is a revenue item, "the taxpayer simply converts future income into present income: see *Commissioner of Internal Revenue v. P.G. Lake, Inc.* (1958) 356 U.S. 260 at pp. 266-267"<sup>73</sup> The payment received for the assignment of the right to interest on the principal is the lender's compensation for being kept out of the use and enjoyment of the principal during the term of the loan, "...and, like the interest for which it is exchanged, it is a profit."

The High Court also stated that it is both immaterial that the profit is received by the lender not from the borrower (Myer Finance) but the other party to the transaction (the assignor) and that the profit is received immediately rather than over the loan period.

It should be noted that in New Zealand the accrual regime (sections 64B - 64M) applies to assignments of income.

Graham Hill<sup>74</sup> points out that profit is being equated with "income". While he says the word "profit" can be used in a way which includes "interest", in the context of the Australian Act, interest is usually regarded as income in ordinary concepts rather than being a "profit".

The United States case of *P.G. Lake* referred to by their Honours concerned

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<sup>72</sup>87 A.T.C. 4363 at p. 4371.

<sup>73</sup>*Ibid.*, p. 4371.

<sup>74</sup>Hill, *A Pre-Bicentennial Reminder of Our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 Taxation in Australia, No. 1, p. 14.



the assignments of oil and sulphur payment rights. The United States Supreme Court took a substance approach to the assignments. The Court held that the lump sum payments that were received for the assignments of the right to receive income were income because they were in substance a substitute for the right to receive future income.

Taylor and Rankin state:<sup>75</sup>

This substance approach does not recognise the distinction advanced by Murphy, J. [in the Supreme Court of Victoria] between the assignment of a right to receive future interest and an agreement to assign future interest payments. In the context of the facts of the *Myer Case* the \$45.37m. was in substance a substitute for the right to receive interest income in the future and hence income itself.

The substance approach effectively copes with the concern that stems from the potential erosion to the tax base that would arise if income receivable under a right to receive income was allowed to be turned into a non-taxable capital sum through this type of scheme. This erosion would be further exacerbated in situations like the *Myer Case* if the income received by the assignee (Citicorp) could be set against losses and the payer of interest (Myer Finance) could obtain a deduction for the interest paid. It is interesting to note that the *Myer Case* was a test case and if Myer had been successful it would have resulted in fifteen companies "minimising" tax to the tune of \$100m.

The \$45,370,000 was according to their Honours received merely in exchange for rights to income (the substitution argument). I.C.F. Spry comments: "However only a passing reference appears to have been made to this argument, probably for the reason that it cannot withstand critical analysis".<sup>76</sup>

In this respect the statements of their Honours in the High Court can be contrasted with the discussion on this point by the lower courts.

In the Supreme Court of Victoria *Murphy J.* referred to the Australian and English decisions which considered income as a compensation receipt. He found that a receipt that is received in substitution for a payment can only be income as a compensation receipt to the taxpayer where the taxpayer has received the payment, or possibly where it falls due. Whether this type of payment is received by the

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<sup>75</sup>Taylor and Rankin, *The Myer Case and the Taxation of gains in 1988*, 11 The Sydney Law Review, p. 627.

<sup>76</sup>Spry, *The Implications of the Myer Emporium Case*, (1987) 15-16 Australian Tax Review, p. 156.

taxpayer will depend on the nature of the agreement between taxpayer and assignee.

In an agreement to assign future interest payments, the future payments are received by the taxpayer. Accordingly any receipt that is received in substitution for the future payments will be income. This he said could be compared to the situation where the agreement between the taxpayer and assignee is an agreement to assign the right to future payments, the future payments will not be received by the taxpayer. In that situation any payment that is received in substitution for the future payments will be capital not income.

His Honour believed the assignment by Myer to be the assignment of a right to interest over 7 1/4 years and accordingly as the lump sum was received in substitution for the right to interest it was capital and not income. He found the right to future interest payments to be in the nature of a wasting asset which may produce income.

This wasting nature was alluded to in the High Court also when their Honours looked at the economic equivalence basis of accounting for the right of interest. The right to interest on that basis will be brought to account at the start of the period at a maximum figure. Over the term of the loan the figure reduces, until at the expiration of the loan it has a nil value.

In the Federal Court, *Lockhart J.* stated:<sup>77</sup>

In no sense could the sum received from Citicorp be regarded as profit. Before the assignment the taxpayer had a right to repayment by Margosa [Myer Finance] of the principal sum of \$80 million and interest thereon over a period of a little more than seven years. After the assignment the taxpayer retained its rights to repayment of the \$80 million but had assigned its rights to interest. What it received in substitution from Citicorp was the present value of its rights to interest over the period of the loan, a capitalisation of its entitlement to interest. There is no element of profit in that receipt. (emphasis added)

In the same Court, *Fox J.* stated:<sup>78</sup>

The amount of interest payable over the entire term was discounted, or from the taxpayer's point of view, capitalised. The sum received was not an aggregate of interest to fall due... That the assignee was merely receiving a right was evident to it, and it insisted on guarantees from the related companies.

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<sup>77</sup>85 A.T.C. 8601 at p. 4611.

<sup>78</sup>Ibid., p. 4606.

It is not correct to treat the sum received as being in substitution for interest, because it has its own independent character. It did not derive from some accidental or extraordinary circumstance, but a positive commercial dealing with a third party.

Of importance in this regard is also the analysis by *Dixon* and *Evatt J.J.* in *C. of T. (Vic.) v. Phillips* which was discussed in all three courts. The crucial passage is:

It is true that to treat a sum of money as income because it is computed or measured by reference to loss of future income is an erroneous method of reasoning ... It is erroneous because, for example, the right to future income may be an asset of a capital nature and the sum measured by reference to the loss of the future income may be a capital payment made to replace that right. Or, again, the computation may be done for the purpose of ascertaining what capitalized equivalent should be paid for the future income.<sup>79</sup>

In respect of the analysis in *Phillips* case the High Court judges, in *Myer*, in the words of I.C.F. Spry:

...appeared to attempt to avoid reasoning of this kind by stating the view that 'interest which becomes due is not the produce of the mere contractual right to interest severed from the debt for the money lent'. This statement is not correct unless it is meant merely that the contractual right to interest may depend upon the satisfaction of conditions set out in the relevant loan agreement, such as the existence of an outstanding principal sum; and if it is understood on this limited basis it does not assist the reasoning of the High Court.<sup>80</sup>

As stated earlier arguably the source of the interest paid to Citicorp from Myer Finance was the assigned contractual right to interest.

(a) Paget's Case. The High Court (and lower courts) referred in some detail to the decision of *I.R. Commrs v. Paget*. The High Court after touching on the case earlier came back to discuss it further in relation to the second strand.

Their Honours in the High Court cited *MacKinnon L.J.*, who described the item Miss Paget had sold as,<sup>81</sup> "the possibility of making some money abroad" when she accepted in lieu of the promised interest, certain payments in local currency or a mixture of both U.S. dollars and funding bonds.

The High Court stated that the coupons were (i) the sole source of this possibility of making money abroad; and (ii) the sole source of the expectation of

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<sup>79</sup>(1936) 55 C.L.R 144 at p. 156.

<sup>80</sup>Spry, *The Implications of the Myer Emporium Case*, (1987) 15-16 Australian Tax Review, p. 156.

<sup>81</sup>(1938) 2 K.B. 25 at p. 48.

substitutionary payment.

This substitutionary payment that was offered by the defaulting borrowers on the production of the coupons was not regarded as interest and the sale of the coupons was not by way of assignment of a right to interest income. Rather the sale of the coupons was in the words of the High Court "...by way of transfer of the instruments of title to the substitutionary payment. The coupons had come to represent, like a contract to pay an annuity, the sole source of the expected payments."<sup>82</sup>

Their Honours referred to but did not quote Lord *Romer's* analogy in *Paget*:

The proceeds of the sale for a lump sum of an annuity, for instance, are capital in the hands of the vendor and not income. And this is true even when the subject of the sale is not the annuity for its whole duration but the right to be paid the annuity for a number of years or even for one year.<sup>83</sup>

The High Court reiterated its earlier statement, and at the same time distinguished *Paget*, by stating:

Unlike the sale of the coupons in *Paget*, the sale of a right to interest severed from the debt is not a sale of a tree of which the future payments are the fruit. The present case may thus be distinguished from the view of the facts which was the foundation of the decision in *Paget*.<sup>84</sup>

Taylor and Rankin believe the distinction between a right to interest and a right to an annuity to be "inconsistent with the substance approach... Annuity payments are received by a taxpayer in respect of a right to receive income. Hence consideration received on assignment of a right to an annuity is, in substance, a substitute for a right to receive income".<sup>85</sup>

(b) A Note on *Paget's* Case. The facts in *Paget's* case were different from those in *Myer*. In particular Miss *Paget* did not acquire the coupons with the view of immediately selling the right to the interest on them. As Graham Hill observes, this

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<sup>82</sup>87 A.T.C. 4363 at p. 4372.

<sup>83</sup>(1938) 2 K.B. 25 at pp. 44-45.

<sup>84</sup>87 A.T.C. 4363 at p. 4372.

<sup>85</sup>Taylor and Rankin, *The Myer Case And The Taxation of Gains in 1988*, 11 The Sydney Law Review, p. 627.

point is more relevant to the first argument (re profit-intention) than the High Court's second argument: "Indeed there is much to be said for the view that the Court throughout most of the judgment linked the two arguments together rather than treated them separately."<sup>86</sup>

There are obvious analogies between the assignment of interest and the assignment of other income streams such as royalties and rent related to a main asset. The High Court did not consider these.

(c) The Last Word on *Paget's Case*. In respect of this case the High Court stated - "If *Paget* is not to be distinguished in this way, [described at (a) above] we should be unable to accept its authority for the purposes of the Act."

Graham Hill comments:

With respect it is hard to see that any of the judges in *Paget's* case analysed the problem in the way the High Court suggested. It seems simpler to merely accept that *Paget's* case was not an appropriate authority in Australia.<sup>87</sup>

(d) A profit of \$45,370,000. The High Court stated that the sale of the right to interest produced for Myer an immediate cash receipt of \$45,370,000. For the outlay (loan) of \$80,000,000, Myer acquired from Myer Finance a debt of \$80,000,000. Myer had made a profit of \$45,370,000.

(4) Conclusion - section 25(1)

Their Honours concluded on the basis of what they had said that the sum received formed part of the income of Myer under section 25(1) of the Australian Act.

(5) Section 26(a)

The Court dealt with this by stating a similar chain of reasoning would have led to the conclusion that the receipt was assessable income under the second limb of section 26(a) (being a profit arising from the carrying on or carrying out of a profit making undertaking or scheme).

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<sup>86</sup>Hill, *A Pre-Bicentennial Reminder of Our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 Taxation in Australia, No. 1, p. 17.

<sup>87</sup>*Ibid.*, p. 17.

As noted by I.C.F. Spry,<sup>88</sup> for the purposes of section 26(a) the relevant profit must be established on ordinary commercial principles. He refers to the cases of *F.C. of T. v. Becker*<sup>89</sup> and *Steinberg v. F.C. of T.*<sup>90</sup>

Spry observes:

There is however extreme difficulty, if not an impossibility, in maintaining that the amount of \$45,370,000 represented a profit on any commercial basis, or indeed on any other reasonable basis. In consideration of payment of an amount of \$80 million Myer obtained (a) a right to a repayment of that amount after more than seven years and (b) a right to interest payments meanwhile. On the basis that a commercial interest rate was agreed upon, the present value of items (a) and (b) together amounted to \$80 million. It would hence not be possible to treat the proceeds of (b) as a simple profit without taking into account the proceeds or value of (a) and the amount of \$80 million that had been paid.<sup>91</sup>

He comments that put another way, Myer paid \$80,000,000 (a capital sum) in consideration of (i) a right to be repaid the capital amount (which he calls "the capital right") assumed to be worth \$34,630,000 by discounting at a commercial rate; and (ii) a right to be paid interest (called "the interest right"). This interest right is assumed on the same basis, to be worth \$45,370,000. The interest right was therefore sold for its value.

It accordingly appears to be incontrovertible that no profit was obtained by the sale of the interest right at its market value; and the decisions of the Supreme Court and the Federal Court to this effect were, it may be thought, clearly correct.<sup>92</sup>

Their Honours decided that it was unnecessary to examine the relationship between section 25(1) and section 26(a).

I do not propose to deal with that relationship in this paper. One commentator<sup>93</sup> has however stated that the *Myer* decision seems to bring together the co-relationship between section 25(1) and the second limb of section 26(a).

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<sup>88</sup>Spry, *The Implications of the Myer Emporium Case*, (1987) 15-16 Australian Tax Review, pp. 153-154.

<sup>89</sup>(1952) 87 C.L.R. 456.

<sup>90</sup>(1975) 134 C.L.R. 640.

<sup>91</sup>Spry, *The Implications of the Myer Emporium Case*, (1987) 15-16 Australian Tax Review, pp. 153-154.

<sup>92</sup>*Ibid.*, pp. 153-154.

<sup>93</sup>Mews, *Recent Trends in Sections 25 & 51 - A Commercial Approach ?*, (1987) 22 Taxation in Australia, No 4, p. 220.

(6) Section 260

The possible application of section 260 of the Australian Act was a significant matter in the application for special leave to appeal to the High Court. However in the light of the High Court's conclusion that the receipt constituted income in ordinary concepts, it was unnecessary for their Honours to decide whether section 260 applied.

(7) Conclusion of the *Myer* Decision

(a) The Full High Court held that the lump sum payment made to Myer for the assignment of its right to receive interest under a loan was assessable to Myer. The sum was derived on income account. The High Court's reasons and findings can be summarised as follows:

(i) ...a gain made otherwise than in the ordinary course of carrying of the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income. Whether it does depends very much on the circumstances of the case. Generally speaking however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business.

A profit or gain made from an isolated venture or "one-off" transaction may also be characterised as income on the same basis.

(ii) A contractual right to interest is not the source of the interest to which it relates. A contractual right that is severed from the debt is not the structure that produces the interest income. When a lender sells his right to interest for a lump sum, the taxpayer is simply converting future income into present income.

(iii) The transactions in the case were entered into by Myer in the course of its business. Although the transactions, in particular the assignment, were novel in the sense it was the first time that Myer had entered into such an arrangement, that fact did not take them out of the course of the carrying on of Myer's profit-making business.

(iv) It was not possible to describe the transactions, or the assignment

on its own, as the mere realisation of a capital asset. The assignment was related to the loan agreement. The loan agreement would not have been entered had Myer not known that Citicorp would shortly thereafter take an assignment of the money's due or to become payable for a lump sum. The two transactions were integral and essential elements in a profit-making scheme.

(b) *Myer* has extended the reach of the concept of income by treating any gain made in the course of carrying on a business or in what is merely a commercial transaction as income.

(c) The approach of the High Court in *Myer* in respect of what forms part of the taxpayer's business has been adopted in a number of subsequent decisions with the result that in some cases a broad view of the taxpayer's business has been taken. The result being that fewer receipts fall outside the taxpayer's business. This expansion of the concept of business is evident in some of the decisions discussed later in this thesis.



## CHAPTER II

### POST-MYER: RECENT AUSTRALIAN DECISIONS

#### INTRODUCTION

"...it may confidently be asserted that the [*Myer*] decision represents a landmark in tax jurisprudence and will be of continuing significance long after its expensive consequence to the respondent to the appeal are forgotten."<sup>1</sup>

Graham Hill was correct. Since the *Myer* case a number of subsequent decisions have followed or have been influenced by that decision. Perhaps the most notable decision being *F.C. of T. v. Cooling* which is discussed in a subsequent chapter.

In this chapter it is proposed to look at the application of the *Myer* case in a number of subsequent cases and the comments made in those decisions.

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<sup>1</sup>Hill, *A Pre-Bicentennial Reminder of our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 *Taxation in Australia*, No 1, p. 12.

# 1. *F.C. of T. v. SPEDLEY SECURITIES LTD*<sup>1</sup>

## (1) Introduction

*Spedley* is one of the more important cases discussed in this thesis, apart from *Cooling* and perhaps *Westfield Ltd. v. F.C. of T.*<sup>2</sup> In *Spedley* the Full Federal Court 'defined' as much as they could the boundaries of the *Myer* decision. The case arose from an appeal by the Commissioner from an unreported decision of the Administrative Appeals Tribunal.

The appeal was before *Fox, Fisher and Sheppard J.J.* *Fox J.* it will be recalled had been one of the three judges who had heard the *Myer* case in the Full Federal Court.

## (2) The Facts of the Case

*Spedley* was a merchant bank. It had agreed to secure the equivalent of \$65,000,000 by way of loan for a mining enterprise that Santos was about to carry out in South Australia. The agreement provided that commission was payable to Santos at 1.25% of the amount of the loan.

The agreement between *Spedley* and Santos was however terminated. Santos paid a lump sum payment of \$200,000 to *Spedley* under a deed of discharge. The immediate cause of the termination was the introduction of legislation that reduced the percentage any one shareholder could own of the issued shares of Santos.

A discharge was executed on 23 April 1980 which was at or about the time of the payment, but months after the agreement had come to an end (in about July 1979). *Spedley* had done most of the work necessary to arrange the finance by July. It had found prospective lenders from overseas. The main items remaining to be done were documentation and the approval of the Reserve Bank.

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<sup>1</sup>88 A.T.C. 4126.

<sup>2</sup>91 A.T.C. 4234.

The \$200,000 lump sum was arrived at after negotiation. There was however no agreement as to how the lump sum was made up. The evidence in the Administrative Appeals Tribunal was fairly light.

The Tribunal had found:

...the receipt...was one whereby for a lump sum payment all claims that S. Securities Limited had, or might have had, against M.C. Limited were resolved. The claims so resolved included a claim for the effect that the termination had or might have had upon the reputation, standing and goodwill of S. Securities Limited and it may have included an amount in respect of expenses or disbursements incurred. There was however, no differentiation of the one item from the other...[the release document] was intended to preclude any right of action in the future that the one may have had against the other...<sup>3</sup>

The lump sum payment was made as a "first and last offer", and "in release of all claims", without apportionment or any indication whether or not an element of a fee was included.

The agreement concerning the payment was accepted and binding on Santos, however, apparently was executed only by Spedley.

The Commissioner subsequently assessed *Spedley* on the \$200,000 payment. The Commissioner argued that:

(a) On the construction of the deed and analysis of the facts, the lump sum was paid not for loss of reputation but for loss of commission and was therefore assessable. The release was illusory. The lump sum must have represented part of the agreed commission under the terminated agreement.

(b) On the basis of the decision in the *Myer* case, the lump sum had been received by Spedley in the course of operations which were intended to produce a profit. The payment was therefore assessable.

### (3) The Decision of the Court

(a) Briefly on the first point, the Court said that the discharge document related to all possible claims that could arise as a result of the termination of the agreement. Assuming that the deed was effective, it would bar legal proceedings. Spedley and its advisers believed an action would lie for damages for loss of

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<sup>3</sup>88 A.T.C. 4126 at p. 4128.

reputation and damage to goodwill. There was no basis for saying that the release was illusory. It was undoubtedly meaningful and of practical importance as far as Santos were concerned.

It was possible that part of the agreed commission had played a part in reaching the figure of \$200,000. There was however evidence that Spedley was concerned about its reputation in the international money market, with this being its largest endeavour in its short history. Its international (and national) standing was its main concern.

Accordingly on the evidence at least a substantial portion of the \$200,000 payment was recompense for damage to its reputation.

(b) The second of the Commissioner's submissions relied on the High Court decision of *Myer*.

In an important passage that is referred to more than once in subsequent cases, the Court in *Spedley* stated:

The decision in that case [*Myer*] was given jointly by five Judges, doubtless with some recognition that the Court was reversing cumulative decisions of the Supreme Court of Victoria, and this Court on a question of whether a receipt was, on the application of the *Income Tax Assessment Act 1936* (the "Act") sec. 25(1), one of capital or income. The case is strong authority for what it decides, but it may only have taken a different view of the facts than had the lower courts. The use made of the decision in this case on behalf of the Commissioner is to say that the amount in question was received in the course of business operations, the operations, taken broadly, being intended to produce a profit. The phrase "in the course of" involves a temporal connection. If the proposition were correct, it would mean that any receipt by a business would necessarily be of an income nature, and this would be contrary to authority, to the Act itself and to basic concepts concerning the distinction between capital and income. In *Myer* what was received related solely to income by way of interest on a loan made by the taxpayer, the amount received being for a transfer of the right to receive the interest in the future. The High Court did not base its decision on *Myer* being, in a broader sense, a profit-making company. The purpose of profit making must exist in relation to the particular operation.<sup>4</sup>(emphasis added)

Their Honours rejected the Commissioner's argument as drawing too wide a conclusion from the *Myer* case. The Commissioner's argument, if accepted, would have meant that any business receipt would be of an income nature. Accordingly the distinction between income and capital would disappear. Such a conclusion "...would

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<sup>4</sup>*Ibid.*, p. 4131.

be contrary to authority, to the Act itself and to basic concepts concerning the distinction between capital and income."

A commentator has noted "...as pointed out in *Spedley*,...taken to its ultimate conclusion, all gains made by a business on commercial transactions would be of an income nature."<sup>5</sup>

On the facts in the present case, the payment included recompense for damage to goodwill, a capital item. The payment was made in a lump sum, with no ingredients identified. However the payment included compensation to injury of capital assets. Accordingly as no apportionment was made (by the parties to the agreement) the Court held that the whole receipt was a capital receipt (*McLaurin v. F.C. of T.*;<sup>6</sup> *Allsop v. F.C. of T.*<sup>7</sup>

The Tribunal had found that there was no evidence in the case as to the size of the expenditure incurred by *Spedley*. It was not clear what part these disbursements played in the final settlement. Nor was there any evidence of any relevant claim for an income tax deduction in respect of it.

The Commissioner's appeal was accordingly dismissed.

#### (4) Conclusion

In finding that the payment was a capital receipt the Court rejected the Commissioner's attempt to argue a broad interpretation of the *Myer* decision, i.e., that the amount was received in the course of the business operations, the operations being to produce a profit, and therefore the amount was assessable.

Their Honours also make an interesting comment that has not been picked up in subsequent decisions: "The case is strong authority for what it decides, but it may only have taken a different view of the facts than had the lower courts."

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<sup>5</sup>Williams, *Lease Inducement Payments Capital or Revenue?* (1990) New Zealand Tax Planning Report, No. 5, p. 35.

<sup>6</sup>(1961) 104 C.L.R. 381.

<sup>7</sup>(1965) 113 C.L.R. 341).

In addition their Honours also qualify what profit-making purpose must exist:

"The purpose of profit-making must exist in relation to the particular operation."

2. *MOANA SAND PTY LTD.v.F.C. of T.*<sup>1</sup>

(1) Introduction

This appeal brought by the taxpayer and was heard by *Sheppard, Wilcox* and *Lee J.J.* in the Federal Court. The case illustrates the application of the *Myer* decision.

The case concerned the inclusion of an amount in the company's assessable income representing a surplus that it received when land it owned on the coast south of Adelaide was resumed. Moana Sand were paid \$500,000 by the resuming authority. Of the \$500,000, \$370,000 was paid during the year ended 30 June 1980, the balance in the following income year. The Commissioner sought to assess the taxpayer on the whole of the sum of \$500,000 less the cost of the land and certain expenses in the 1980 tax year.

The taxpayer's objection was referred to the Administrative Appeals Tribunal. The Tribunal held that the profit derived from the sale of the land was assessable under section 25 and the second limb of section 26(a) of the Australian Act. However the Tribunal decided that only the sum of \$370,000 less expenses and costs should be assessable.

Moana Sand appealed to the Federal Court.

(2) The Facts of the Case

The principal of Moana Sand was a Mr Roche. The land was acquired in 1941 by another company that Mr Roche was associated with. In 1951 the land was transferred to Mr Roche as nominee for a family syndicate.

Moana Sand was formed by Mr Roche in 1955. Its one object, contained in its Memorandum of Association was in the words of the Court to "acquire, purchase and take over certain lands for the purpose of carrying on the business of working and/or selling the sand thereon 'and to do all things necessary for carrying out the above...'"

In February 1956 Mr Roche received a notice of an application to mine the

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<sup>1</sup>88 A.T.C. 4897.

land. Some correspondence followed with the Department of Mines, as Mr Roche objected to the application, stating inter alia, that he held the land for the purpose of subdividing it into building allotments and that much of the preliminary work had been carried out.

On 30th June 1958 Moana Sand entered an agreement to buy the land from the family syndicate for 2000 pounds paid by way of deposit and their balance by yearly instalments.

In 1964 Mr Roche met the Town Clerk to discuss whether the local council would permit the land to be subdivided in the future.

The land was rezoned "rural" in 1973, notwithstanding his objections. The Coast Protection Board expressed an interest in preserving the land, especially the sandhills. The Board resumed the land in December 1979, after negotiations, for \$500,000. Of this sum, \$370,000 was paid in the 1980 income year, the balance in the following year.

### (3) The Submissions

The Commissioner submitted that subsection 25(1) and the second limb of subsection 26(a) applied. In reliance of section 25, the Commissioner argued that the receipt was income according to ordinary concepts or usages.

The Commissioner also argued that the sum was assessable under the second limb of section 26(a) of the Australian Act which provided the assessable income of a taxpayer includes the profit arising from the carrying on or carrying out of a profit-making undertaking or scheme. The Commissioner submitted that it was established by the Tribunal, that the land was acquired by the company with the twofold purpose of working and/or selling the surplus sand and thereafter holding the land until a future time when the land would be sold at a profit. While this latter purpose of resale was not the dominant purpose of the company in acquiring the land, the subdivision of the land ultimately for profit remained the purpose of the company from the time of purchase until the land was resumed by the Coast Protection Board. Consequently the carrying on or carrying out of a profit-making undertaking or



*Syndicate Limited*.<sup>4</sup>

Their Honours then stated the important proposition in the above two cases as per *Myer* was that:

...a receipt might constitute income if it arose from an isolated business operation or commercial transaction entered into otherwise than in the ordinary course of the carrying on of the taxpayer's business, so long as the taxpayer entered into the transaction with the intention or purpose of making a relevant profit or gain from the transaction...<sup>5</sup>

Their Honours quoted from the passage of the High Court in *Myer*<sup>6</sup> concerning the "proposition that a mere realisation or change of investment is not income." In this discussion their Honours in *Myer* stated:

...profits made on a realization or change of investments may constitute income if the investments were initially acquired as part of a business with the intention or purpose that they be realized subsequently in order to capture the profit arising from their expected increase in value,

and

...it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction.

On the basis of the statements in *Myer*, as the land had been acquired with an intention of subdivision in the future (after the sand had been worked or sold) as found by the Administrative Appeals Tribunal, it is not surprising that the Court concluded the surplus after expenses was assessable.

Their Honours in *Moana Sand* concluded under this head by stating:

In our opinion it is clear that the amount received by the company in the present case, notwithstanding that it was received as the result of a single and, in a sense, isolated transaction, was assessable income according to ordinary concepts. After the deduction of expenses incurred in the acquisition of the land, the surplus was properly brought to tax.<sup>7</sup>

Their Honours rely on a number of cases including *Californian Copper*,

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<sup>4</sup>(1928) A.C. 132 at pp. 140-142.

<sup>5</sup>88 A.T.C. 4897 at pp. 4902-4903.

<sup>6</sup>*F.C. of T. v. The Myer Emporium Ltd* 87 A.T.C. 4363 at pp. 4368-4369.

<sup>7</sup>88 A.T.C. 4897 at p. 4903.

*Ducker* and *Myer* for their conclusion. There is however little application of the principles in these cases to the actual facts of this case.

(b) Section 26(a)-the Second Limb. The Court held for the second limb to apply it was not necessary that the taxpayer's dominant purpose be to make a profit. This was important because the Administrative Appeals Tribunal found the dominant purpose for the formation of *Moana Sand* and the purchase of the subject property was the working and/or selling of sand not the sale of the property for a profit.

Their Honours cited a number of authorities and quoted *Gibbs J.* in *F.C. of T. v. Bidentope*<sup>8</sup> who said, inter alia:

If a scheme is designed to secure a profit, it is a profit-making scheme, although it has other purposes as well. This was I think recognized by *Jacobs J.* in *London Australia Investment Co. Ltd. v. F.C. of T.* 77 ATC 4398 at p. 4409...when he said that if the acquisition and disposal of property is part of a business of so doing, the purpose of resale need not be the sole purpose, or the primary or dominant purpose, as is the case under the first limb of sec. 26(a). The present is of course not a case in which property was acquired for resale, but once it is established that profit arose from the carrying on of a scheme, it is enough that the making of a profit of that kind was one of the purposes of the scheme...

Their Honours in *Moana Sand* did however state: "Obviously, however, the scheme could not be a profit-making scheme unless those devising it and participating in it had the purpose of profit-making as one of their purposes."<sup>9</sup>

Consequently the 'surplus' was assessable pursuant to the second limb of section 26(a), being a profit earned as the result of the carrying on or carrying out of a profit-making scheme.

(c) Was this the Conclusion of a Scheme? Counsel for *Moana Sand* submitted that the sale, which was forced upon the company, was not a sale undertaken in the carrying out of the scheme, rather it was one that brought the scheme to an end. "Likewise the sale was not one undertaken pursuant to any profit-

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<sup>8</sup>78 A.T.C. 4222 at p. 4234.

<sup>9</sup>88 A.T.C. 4897 at p. 4904.

making purpose or intention but was one thrust upon the company by force of law."<sup>10</sup> Counsel for the company relied on the decision of *Menzies J. in Kratzmann v. F.C. of T.*<sup>11</sup> in support of its submissions.

Moana Sand's attempts to sell the land over a number of years had only been moderately successful; at the time of the compulsory acquisition the sandhills were still substantial and the company had not reached the stage where it would either subdivide the land or transfer it either to an associate or to a third party, at a profit.

The Court after it had discussed a number of authorities, distinguished the present case from *Kratzmann* on the basis: "[that the] sale of the land, albeit pursuant to the compulsory acquisition, was the fulfilment of the ultimate purpose of the company in relation to the land."<sup>12</sup> Their Honours dismissed the appeal.

#### (5) Conclusion

The case illustrates the application of the *Californian Copper* and *Myer* decisions in respect of an amount received for the resumption of land. On the basis of these cases, and with little other discussion the court concluded the amount received as the result of a single and, in a sense, isolated transaction was income according to ordinary concepts.

On the basis of other authorities in respect of the second limb of section 26(a) the Court held it was unnecessary for profit-making to be the dominant purpose of the taxpayer.

This was important as the Administrative Appeals Tribunal had found the dominant purpose for the formation of the company and purchase of the land was the working and/or selling of sand. The surplus that arose on the resumption of the land was profit earned as a result of the carrying on or carrying out of a profit-making scheme by Moana Sand. The amount was accordingly assessable under the second limb of section 26(a).

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<sup>10</sup>Ibid., p. 4904.

<sup>11</sup>70 A.T.C. 4043.

<sup>12</sup>88 A.T.C. 4897 at p. 4905.

3. *G.P. INTERNATIONAL PIPECOATERS PTY. LTD. v. F.C. of T.*<sup>1</sup>

(1) Introduction

This was an appeal from the decision of the Full Federal Court. The decision was a joint decision of *Brennan, Dawson, Toohey, Gaudron* and *McHugh* J.J. in the Full High Court. As with *Moana Sand*<sup>2</sup> this case is an illustration of the application of the principles enunciated in the *Myer* case.

(2) The Facts of the Case

The taxpayer was a joint venture company that was incorporated for the sole purpose of tendering and carrying out a contract with the State Energy Commission of Western Australia ("S.E.C.W.A."). The contract was to supply internal and external coatings for pipes to be laid for a natural gas pipeline. The taxpayer was also required as part of the contract to construct a plant at which the coating work would be performed. The plant would be of no further use to the taxpayer or S.E.C.W.A. when the contract was completed. S.E.C.W.A. in addition to making payments for the pipes to be completed agreed under the contract to pay "establishment" costs of \$4,675,930 to the taxpayer for the construction of the plant. This was the estimated cost of constructing the plant. This figure was calculated by estimating what the plant would cost and adding 15% for contingencies.

The sum was paid over a six-month period in three equal instalments and before S.E.C.W.A. had received any coated pipes. The reason for the payments was to save the taxpayer having to borrow funds and pay interest on high establishment costs, interest costs which would have been passed on to S.E.C.W.A. Evidence showed that such "up-front" payments to cover establishment costs were not uncommon.

At the time the plant was commissioned, \$4,380,000 had been spent on it.

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<sup>1</sup>90 A.T.C. 4413.

<sup>2</sup>*Moana Sand Pty. Ltd. v. F.C. of T.* 88 A.T.C. 4897.

The taxpayer had however to spend a further \$970,000 upgrading it. For this the taxpayer received an accelerated payment of \$550,000 on account of pipes that were to be delivered. No profit was made by the taxpayer in respect of the construction of the plant. A director of one of the shareholder companies in the taxpayer stated "it was never intended to make a profit from the construction of the plant." When the contract was concluded, the plant which was the taxpayer's property, was sold for its salvage value of approximately \$500,000.

The establishment costs that S.E.C.W.A. paid were apportioned in the taxpayer's accounts over 16 months being the expected life of the project. The taxpayer did not include those payments in its assessable income. In its 1982 tax return, the payment for plant was shown as a current liability in its balance sheet. The actual cost that had been incurred at 30 June 1982 in constructing the plant was shown as capital works in progress at cost in the balance sheet. In its 1983 return, the taxpayer claimed depreciation on the plant and an investment allowance. The Commissioner did not dispute either of these claims.

The Commissioner issued adjustment sheets for the 1983 and 1984 returns in which he included as assessable income the sums of \$3,117,291 and \$1,558,639 respectively, of the establishment costs paid to the taxpayer. These amounts had ceased to be subject to contingency during these income years. There was also an assessment in respect of undistributed profits that the Commissioner claimed arose as a result of those payments made by S.E.C.W.A. being income.

The taxpayer objected to the relevant assessments claiming the moneys received as establishment costs were not part of its assessable income.

In respect of the payments by S.E.C.W.A. for establishment costs:

(a) The taxpayer was not bound by contract to pay the cost of constructing the plant out of the moneys it received as establishment costs from S.E.C.W.A. The taxpayer was free to choose how it financed the construction of the plant. It was however to be put in funds to the extent of \$4,675,930.

(b) None of the three payments specified bore any relationship to the value

of the work which was to be done by the date each payment was made.

(3) The Decision

The question in the appeal to the Full High Court was whether the amounts received as establishment costs were assessable income to the taxpayer within section 25(1) of the Income Tax Assessment Act 1936.

At issue was "the character of the establishment costs as receipts in the hands of the taxpayer. 'Whether or not a particular receipt is income depends upon its quality in the hands of the recipient': *Scott v. F.C. of T.* (1966) 117 C.L.R. 514, per *Windeyer J.* at p. 526."<sup>3</sup>

(a) The Character of the Establishment Costs. At the outset the Court emphasised that in determining the character of the establishment costs, the nature of the expenditure that the taxpayer made in the construction of the plant was not the relevant question (i.e., the use to which the funds received were put was not relevant). Income may be applied in the acquisition of a capital asset or, conversely, a taxpayer may apply a capital receipt in the discharge of a liability which is of a non-capital nature.

In this regard, their Honours<sup>4</sup> referred to the observation of *Cozens-Hardy M.R.* in *Hudson's Bay Co. v. Stevens*<sup>5</sup>, "if the money is otherwise liable to income tax it cannot escape taxation by reason of its being applied to a capital purpose."

Accordingly the Court said a receipt may be income even though the recipient is bound to apply the money for the purpose of discharging a capital liability: *Mersey Docks v. Lucas*<sup>6</sup>; *Commrs. of I.R. v. Corporation of London (as Conservators of Epping Forest)*.<sup>7</sup>

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<sup>3</sup>90 A.T.C. 4413 at p. 4419.

<sup>4</sup>*Ibid.*, p. 4419

<sup>5</sup>(1909) 5 T.C. 424 at p. 436.

<sup>6</sup>(1883) 8 App Cas 891 at pp. 904, 909-910.

<sup>7</sup>(1953) 34 T.C. 293 at p. 329.

The Court noted the necessity in the case before it not to confuse the character of the receipt with the nature of the asset that was acquired by the taxpayer on the application of the moneys received. The substance of the taxpayer's argument was that:

- (i) the plant was a capital asset;
- (ii) the moneys that were expended in its construction were expenditure of a capital nature by the taxpayer; and
- (iii) as those moneys received from S.E.C.W.A. were for the purpose of expenditure in the construction of the plant, the payments were receipts of a capital nature.

Their Honours stated the first two steps may be accepted.

These two steps of reasoning are not dissimilar to the reasoning of *Richardson J.* in *C. of I.R. v. McKenzies N.Z. Ltd.*<sup>8</sup> His Honour in respect of the deductibility of a lump sum payment made to surrender a lease stated:<sup>9</sup>

An appropriate starting point is to consider the character of the asset involved...the lease was itself a capital asset of the company...

Next, in an uncomplicated case the characterisation of the asset acquired or disposed of will determine the character or quality to be attributed to the costs of acquisition or disposal, as the case may be. Just as moneys spent on the acquisition of a capital asset are prima facie regarded as capital expenditure, so too the proceeds of the disposal of a capital asset or the costs of its disposal where it has a negative value should in the ordinary course have the same character. (emphasis added)

The High Court in *G.P. International Pipecoaters* stated that the third step above however, assumed that when money is received for the purpose of being expended by the recipient, the character of the receipt is necessarily determined by the character of the proposed expenditure of the recipient. The assumption was, in their Honours' words, erroneous.

On this point it is important to note the New Zealand Court of Appeal

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<sup>8</sup>(1988) 10 N.Z.T.C. 5237.

<sup>9</sup>*Ibid.*, p. 5237.

decisions *C. of I.R. v. City Motor Service Ltd.*; *C. of I.R. v. Napier Motors Ltd.*<sup>10</sup> in which *North P.* takes a different view. These decisions are discussed in Part C.

(b) Their Honours go on to discuss determining the character of expenditure. Before turning to the character of the receipt, the Court said it was first desirable to consider the means by which the character of expenditure could be determined. The character of expenditure ordinarily is determined by reference to the nature of the asset that is acquired or the liability that is discharged as a result of the expenditure.<sup>11</sup>

...for the character of the advantage sought by the making of the expenditure is the chief, if not the critical, factor in determining the character of what is paid: *Sun Newspapers Ltd. v. F.C. of T.* (1938) 61 C.L.R. 337 at p. 363; *Colonial Mutual Life Assurance Society Ltd. v. F.C. of T.* (1953) 89 C.L.R. 428 at pp. 445-447, 454...

The above approach is again similar to that of *Richardson J.* in *McKenzies* case. The taxpayer in *G.P. International Pipecoaters* expended the sum received from S.E.C.W.A., and more, in constructing the plant which was to be used in pipe coating. The expenditure was capital and the plant depreciable property. Both parties to the case accepted that the plant was a capital asset and the expenditure incurred in its construction was an outgoing of a capital nature.

It did not follow however that the receipt of the "establishment" costs which were expended by the taxpayer to meet the costs of the construction of the plant, were a receipt of a capital nature. Their Honours noted various relevant factors. For example, sometimes the character of receipts is revealed most clearly by their periodicity, regularity or recurrence; sometimes by the character of a right or thing that is disposed of in exchange for the receipt and so forth.

Another means of determining the character of a receipt, appearing from the *Myer* case<sup>12</sup> is the scope of the recipient's business and purpose in engaging in it. In

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<sup>10</sup>[1969] N.Z.L.R. 1010 at p. 1014.

<sup>11</sup>90 A.T.C. 4413.

<sup>12</sup>*F.C. of T. v. The Myer Emporium Ltd.* 87 A.T.C. 4363.



this respect their Honours cited the well-known passage from the High Court's judgment at pp. 4366-4367.

(c) What was the scope of of the taxpayer's business in which the establishment costs were received and what was its purpose in engaging in it? It was submitted by the taxpayer that its business consisted of the coating of pipes, and not in the construction of the plant.

The Court determined the question based on the contract between the taxpayer and S.E.C.W.A. The activity and business of the taxpayer corresponded with the requirements of this contract.

Their Honours found:<sup>13</sup>

The establishment costs were received by the taxpayer under the contract as part of the monetary consideration payable for the taxpayer's agreement to perform, or its performance of, the entire contract. It is impossible to treat the business of the taxpayer as limited to the coating of the pipe when the construction of the pipe-coating plant was an integral part of the work which the taxpayer was bound to perform. The establishment costs were not received under a severable part of the contract relating to the construction of the plant. By constructing the plant and coating the pipe the taxpayer performed the obligations in consideration for which it was entitled to be paid the establishment costs and other moneys payable under the contract. It earned the money by doing the work it had contracted to do. The establishment costs were not received in exchange for an item of capital or a right of a capital nature. (emphasis added)

And later:<sup>14</sup>

The establishment costs were received under the contract which provided that the taxpayer should construct the plant for its own use and...retain ownership of it... To say that the taxpayer made no profit in constructing the plant is to overlook the fact that the taxpayer's receipt of the establishment costs allowed it to construct the plant it needed to perform its contractual obligation of pipe-coating at a net cost to itself which was \$4,675,930 less than the actual cost of construction. This sum was a gain by the taxpayer, made in and by reason of the ordinary course of the business which it carried on.(emphasis added)

This is a broad interpretation of the scope of the business carried on by the taxpayer.

(d) On application of "a business conception to the facts" (per *F.C. of T. v.*

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<sup>13</sup>90 A.T.C. 4413 at p. 4421.

<sup>14</sup>*Ibid.*, pp. 4421-4422.

*Becker*),<sup>15</sup> their Honours said the receipt by the taxpayer of the establishment costs must be classified as a receipt of an income nature. The taxpayer constructed the plant, coated and delivered the pipe as contracted to. It received the establishment costs and the agreed rate on the coating and delivery of pipe. The expenditure on the plant was treated as capital expenditure. The plant was written down to its residual value. There was no disposition of a capital asset during the venture, yet the work performed yielded the establishment costs and amounts received for coating the pipe. If that total sum is treated as the revenue that is derived from the carrying on of the business, the profit is calculated by deducting revenue expenditure incurred in pipe-coating and the depreciation on the plant. This result accorded with business conceptions. To omit the \$4,675,930 receipt from the calculation of a revenue profit after deducting depreciation on the plant would distort those conceptions. If that receipt were so omitted it would require it to be treated as a capital profit, although it was not received as a gift that was intended to replenish capital nor was it received in exchange for a capital asset. The payment to the taxpayer of the establishment costs was a receipt in the ordinary course of carrying on the business of the taxpayer.

(e) The taxpayer submitted that there was authority that a receipt of moneys that is intended by payer and payee to recoup capital expenditure by the recipient is a receipt of a capital nature. When the amount is received by way of gift or subsidy to replenish or augment the capital of the payee this proposition is accepted their Honours said because the receipt cannot be said to be the product or incident of the recipient's income-producing activity. Several cases were cited by their Honours in support of this proposition. In New Zealand see the discussion of *North P.* in the Court of Appeal decisions of *C. of I.R. v. City Motor Service Ltd.*; *C. of I.R. v. Napier Motors Ltd.* at Part C.

Their Honours continued:<sup>16</sup>

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<sup>15</sup>(1952) 87 C.L.R. 456 at p. 467.

<sup>16</sup>*Ibid.*, p. 4422.

But it cannot be accepted that an intention on the part of a payer and a payee or either of them that a receipt be applied to recoup capital expenditure by the payee determines the character of a receipt when the circumstances show that the payment is received in consideration of the performance of a contract, the performance of which is the business of the recipient or which is performed in the ordinary course of the business of the recipient. (emphasis added)

The taxpayer based its submissions on two cases where payments made under a contract to recoup expenditure were held to be capital in the recipient's hands. In respect of the first, an English case *Boyce (H.M. Inspector of Taxes) v. Whitwick Colliery Co. Ltd.*,<sup>17</sup> their Honours believed the decision was not sound in principle and in their opinion should not be followed in Australia. In the New Zealand *City Motor's* case *North P.* quotes *Romer L.J.* in *Boyce* with approval.

The second case, *A.P.A. Fixed Investment Trust Co. Ltd. v. F.C. of T.*<sup>18</sup> was their Honours said distinguishable from the present.

The taxpayer's appeal was dismissed.

#### (4) Conclusion

(a) In determining the character of the payment, the Court focused on the scope of the business in which the taxpayer received the establishment costs and its purpose in engaging in it, per the decision of the High Court in *Myer*. A passing reference was made to other factors such as periodicity, regularity or recurrence. Had other factors been focused on, the conclusion may have been different. The payments of the establishment costs were after all not recurrent or regular. Payment was made over three instalments only.

(b) The basis for their findings was the contract between the taxpayer and payer, S.E.C.W.A.

(c) The Court did not accept that an intention on the part of a payer and payee that a receipt was to be applied to recoup capital expenditure by the payee determined the character of a receipt when the circumstances showed the payment to be received in consideration for the performance of a contract.

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<sup>17</sup>[1934] All E.R. 706.

<sup>18</sup>(1948) 8 A.T.D. 369.

(d) The Court took what can be called a "broad view" of the taxpayer's business. The Lord Justice Clerk in *Western Gold Mines N.L. v. C. of T. (W.A.)*<sup>19</sup> said that it is necessary to undertake "a wide survey and an exact scrutiny of the taxpayer's activities". (emphasis added)

It is arguable that "an exact scrutiny of" the taxpayer's activities may not have been taken. Was not its business the coating of pipe, the construction of plant being incidental to its business?

(e) The feature of this case which influenced the decision of the Federal Court was that the taxpayer was a joint venture company that was incorporated solely for this project. Little mention however was made of this fact in the High Court. It may be correct on this basis to say that all the payments made were in fact received in the ordinary course of the taxpayer's business (as the company was formed to construct the plant and coat pipes).

(f) Did any or all of the "establishment" costs amount to a 'profit'? A profit is normally calculated after deducting related expenditure.

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<sup>19</sup>(1938) 59 C.L.R. 729 at p. 740.

4. *WESTFIELD LTD. v. F.C. of T.*<sup>1</sup>

(1) Introduction

*Westfield* is an extremely important case. In this case *Hill J.* discusses both *Myer* and to a lesser extent *Cooling* (discussed in Chapter III of this part). The appeal was from the decision of *Sheppard J.*<sup>2</sup> and was heard in the Full Federal Court before *Lockhart, Gummow* and *Hill J.J.* *Hill J.* gave the judgment. *Lockhart* and *Gummow J.J.* concurred with *Hill J.*'s reasons and orders.

(2) The Facts of the Case

Westfield was a company mainly involved at the relevant times in the design, construction, letting and management of shopping centres. Where it designed and constructed centres on land it owned, the centres were generally held as long term investments. Sometimes Westfield would sell and lease back the centres as part of a financing arrangement. The taxpayer had also been involved as one of a number of joint venturers who owned and operated shopping centres and also had designed and built centres in which it had no financial interest.

There was no suggestion in the years prior to 1981 that Westfield had carried on a business of buying and selling land or that Westfield or associated companies had ever acquired land for the purpose of resale at a profit. Rather the Court found that the taxpayer only purchased land for future development as described above.

In the early 1970's the Deputy Chairman of Westfield saw the likelihood of growth occurring in a Brisbane suburb. On 8 May 1978, Westfield acquired an option to purchase a block of land that was central to any development in the form of a shopping centre. The option, to remain in force until 31 October 1978, provided for the sale of the land at the price of \$450,000 free of any commission. At the same time Westfield secured options to purchase other allotments in that area.

As a result of roading and other problems, Westfield could not meet the

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<sup>1</sup>91 A.T.C. 4234.

<sup>2</sup>90 A.T.C. 4801.

Brisbane City Council's conditions and abandoned its application to have the land rezoned in January 1980. The owners of the land over which Westfield held options were notified. Approximately three months later Westfield heard that a competitor was interested in a development similar to that proposed by Westfield, and was attempting to secure options over the land.

Westfield therefore obtained further options in April 1980 over the central block of land for a consideration of \$100,000. The consideration for the option being applied, if exercised, as part payment of the \$450,000 purchase price. The option was exercised on 16 April 1981 some six days before it was due to expire. The land was purchased for \$450,000.

At the same time the option was exercised, Westfield was having discussions with the A.M.P. Society with a view to A.M.P. participating in some form in the project.

Negotiations with the A.M.P. Society proceeded culminating in a contract for the sale of the land to A.M.P. for \$735,000 in December 1982. The price being in line with the prices A.M.P. had paid adjoining land owners although much less than one valuation that was obtained. The taxpayer was subsequently engaged to design and construct the shopping centre.

(3) *Sheppard J.'s decision - per Hill J.*

Mr Justice *Hill* analysed the decision of *Sheppard J.*

*Sheppard J.* found that the deputy chairman could not precisely foresee at the time the land was under option and was subsequently purchased, what would happen to the property. However he knew that the:

... land was a powerful card in his hands.

But to take the view that he had purchased the land merely to await the day when someone would be forced to buy from him is to oversimplify the matter. His company [Westfield] was primarily a developer of shopping centres.<sup>3</sup>

*Sheppard J.* found Westfield had always intended, if possible, to have input into the design and construction of the centre. This was its long term objective and

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<sup>3</sup>Ibid., p. 4805.

was evidenced by the fact that once the agreement with the A.M.P. allowing Westfield to design and build the shopping centre had been secured, the sale of the land was a consequential matter.

Accordingly as the land had not been purchased with the dominant purpose of making a profit by sale, the first limb of section 26(a) did not apply. At the time the land was acquired there was no intention necessarily to sell the land. The taxpayer's preference despite its negotiations with the A.M.P. Society was to develop that and adjacent land itself.

His Honour noted that the date the option was exercised and the date of correspondence from A.M.P.'s head office concerning negotiations with the taxpayer, were the same. The evidence showed that the vendors of the land were not prepared to extend the option and therefore Westfield's solicitor was anxious to ensure the option was exercised within time.

*Sheppard J.* was of the view that Westfield would have exercised the option whether or not A.M.P. were interested in the centre concept. Westfield would have held the land in the hope of some form of development taking place in the future.

In these circumstances his Honour believed the profit was assessable on the basis of the cases of *Myer and Jennings Industries Ltd. v. F.C. of T.*<sup>4</sup> He felt he could not separate the sale of the land from the totality of the transaction. The whole transaction including the sale of the land to the A.M.P., was carried out in the ordinary course of Westfield's business and was part of an overall profit-making purpose. The land sale was a necessary step in carrying out the entirety of the venture.

The evidence establishes, as I have said, that the applicant intended, when it acquired the land, to use it in a way which, although not then precisely foreseen, would achieve for it participation in the development of it and other adjacent land into a shopping centre... It did not envisage sale as a necessary consequence. But it was certainly a possibility.<sup>5</sup>

As it happened Westfield sold the land for a profit. The income was, in

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<sup>4</sup>84 A.T.C. 4288.

<sup>5</sup>90 A.T.C. 4801 at p. 4808.

*Sheppard J.*'s opinion profit that was properly included in the assessable income of Westfield. A conclusion, *Sheppard J.* felt was "required by both the *Jennings Industries* and the *Myer case*."

(4) *Hill J.* in the Full Federal Court

(a) The Commissioner's Notice of Contention - A Purpose of Sale when the Property was Acquired. Counsel for the Commissioner claimed that *Sheppard J.* erred in failing to make a number of findings of fact. The Commissioner contended, inter alia, that at the time Westfield exercised the option, it was aware that "There was a real possibility" that the type of deal ultimately concluded with A.M.P. might be made if the option were exercised.

The Commissioner emphasised the submissions and evidence on the coincidence of the exercise of the option and the negotiations between Westfield and A.M.P. An internal letter from A.M.P. head office to its Brisbane office made reference to the possible development of the land.

Evidence given by the General Manager of Westfield, was that the acquisition of the site by A.M.P. opened up the possibility of Westfield "working in" with the A.M.P. Society. At the time Westfield did work in association with various institutions of the type of A.M.P., with whom they developed, and then retained, an interest in the shopping centres.

The Commissioner also relied on a letter which was written after the option to purchase was exercised, by an agent acting for a developer, to a director of Westfield, concerning either the aggregation of various parcels of land or the purchase from Westfield of surplus land. *Hill J.* noted from the lower court judgment that while the Deputy Chairman would not have been surprised by the proposal, there was no evidence as to his response. The matter had not been explored in cross-examination and added nothing to the case.

It was accepted from the evidence:

(i) While at the time the option was exercised, Westfield's Deputy Chairman was aware that A.M.P. were interested in a development of the centre and



owning the land, Westfield did not have a purpose of sale at that time. At the time the option was exercised the Deputy Chairman knew a development would occur but he did not know exactly how.

(ii) It was denied that if a buyer had come along after the option had been exercised and offered a high enough price that the offer would have been considered on its commercial merits. The matter would however have been different if Westfield had been offered a shopping centre contract. Mr Saunders stated "If somebody else would have come along and would offer us five times as much as we paid for the land we would not sell it...we did not buy the land to cash in on the land."<sup>6</sup>

*Hill J.* in the Federal Court stated concerning the notice of contention and evidence of the Deputy Chairman of Westfield:

His Honour [*Sheppard J.*] had the advantage of seeing the witnesses in the witness box. We did not. To find, as inferentially the respondents would have us find, that the appellant [Westfield] had a purpose of selling at a profit, would, notwithstanding the submissions to the contrary, necessarily involve the rejection of Mr Saunders' evidence to the contrary.<sup>7</sup>

In rejecting the notice of contention, *Hill J.* reiterated *Sheppard J.*'s findings that when the option to purchase the land was exercised by Westfield, there was a possibility that the land may be sold to A.M.P. but that was only one of a number of possibilities. Westfield's preference was to develop the land itself. Accordingly the sale of the land was not a purpose of Westfield.

It is important to note the Commissioner's aggressive stance arguing that *Sheppard J.* had erred in his findings.

(b) Assessable Income. The heart of the appeal was the question whether the profit made by Westfield constituted assessable income.

As also stated in *Moana Sand Pty. Ltd. v. F.C. of T.*<sup>8</sup> and other cases the starting point for the Court was the now well used phrase of Lord Justice Clerk in

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<sup>6</sup>91 A.T.C. 4234 at p. 4239.

<sup>7</sup>*Ibid.*, pp. 4239-4240.

<sup>8</sup>88 A.T.C. 4897 at p. 4902.

*Californian Copper Syndicate v. Harris*.<sup>9</sup> Where an owner of an ordinary investment realises it for an enhanced price that profit is not assessable. However enhanced values from the realisation or conversion of securities may be assessable when what is done is not merely a realisation or change of investment but an act done in the carrying on or carrying out of a business.

Hill J. referred to the necessity to undertake "a wide survey and an exact scrutiny of the taxpayer's activities" per the Lord Justice Clerk in *Western Gold Mines N.L. v. C. of T. (W.A.)*.<sup>10</sup>

Hill J. then referred to the *Myer* case<sup>11</sup> and *G.P. International Pipecoaters Pty. Ltd. v. F.C. of T.*<sup>12</sup> where the test in *Californian Copper* was applied.

In *Myer*, it was argued by the taxpayer that the receipt, in the words of Hill J. in *Westfield* "...was not income in ordinary concepts, because it was an extraordinary transaction and outside the scope of the taxpayer's business."<sup>13</sup>

In response to this argument, Hill J. quoted the well known passage from the High Court's judgment in *Myer*<sup>14</sup> to effect that a receipt may constitute income if it arises from an isolated business operation or commercial transaction that is entered into otherwise than in the course of the carrying on of the taxpayer's business, so long as the taxpayer entered into the transaction with the purpose of making a relevant profit or gain from the transaction.

Hill J. commented in respect of that passage:<sup>15</sup>

The judgment, not only in this passage, but in several later passages...emphasises that where a transaction occurs outside the scope of ordinary business activities, it will be necessary to find, not merely that the transaction is 'commercial' but also that there was, at the time it was entered

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<sup>9</sup>(1904) 5 T.C. 159 at pp. 165-166.

<sup>10</sup>(1938) 59 C.L.R. 729 at p. 740.

<sup>11</sup>*F.C. of T. v. The Myer Emporium Ltd.* 87 A.T.C. 4363.

<sup>12</sup>90 A.T.C. 4413.

<sup>13</sup>91 A.T.C. 4234 at p.4241.

<sup>14</sup>87 A.T.C. 4363 at pp. 4366-4367.

<sup>15</sup>91 A.T.C. 4234 at pp. 4241- 4242.

into, the intention or purpose of making a relevant profit.

What was said in *Myer* has been applied in a number of cases in this court since. Among them are *Moana Sand Pty Limited v FC of T* 88 ATC 4897, and *FC of T v Cooling* 90 ATC 4472; (1990) 22 FCR 42. It does not, however, follow from the judgment in *Myer*, or for that matter, from the judgments in any later cases, that every profit made by a taxpayer in the course of his business activity will be of an income nature. To so express the proposition is to express it too widely, and to eliminate the distinction between an income and a capital profit. A taxpayer carrying on a business might sell its headquarters in order to move to larger premises and make a profit over historical cost. The transaction of sale may be one which arises in the ordinary course of the taxpayer's business, but that profit will not ordinarily be income, particularly where, at the time of acquisition of the site, there was no intention or purpose of profit-making by sale when the premises became too small. The profit in *Cooling*, the receipt of a leasing incentive payment, was one intended to be made at the time the transaction with the lessor was entered into, just as the profit in *Myer* was one which underlay the whole transaction.

The following points can be made in respect of his Honours comments:

(i) *Hill J.* on the basis of *Myer* states there are two ingredients for a profit to be assessable when a transaction occurs outside the scope of the ordinary business activities:

(a) the transaction must be "commercial"; and

(b) there must have been at the time the transaction was entered into, the intention or purpose of making a relevant profit.

It is unclear what type of transaction is "commercial". Presumably most transactions entered into by a business will by their very nature be "commercial", having been entered into by the taxpayer in the course of carrying on its business. The first ingredient therefore appears largely unnecessary.

(ii) It does not, however, follow from the judgement in *Myer*...that every profit made by a taxpayer in the course of his business activity will be of an income nature. To so express the proposition is to express it too widely, and to eliminate the distinction between an income and a capital profit.

This appears to reflect both the statements in *F.C. of T. v. Spedley Securities Ltd.*<sup>16</sup> and comments of various commentators.

In *Spedley* the Commissioner argued, on the basis of *Myer*, that the amount received by the taxpayer when the loan agreement was terminated was received in the course of business operations which, taken broadly, were intended to produce a

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<sup>16</sup>88 A.T.C. 4126.

profit. Their Honours in the joint judgment rejected the Commissioner's proposition:<sup>17</sup>

If the proposition were correct, it would mean that any receipt by a business would necessarily be of an income nature, and this would be contrary to authority, to the Act itself and to basic concepts concerning the distinction between capital and income. (emphasis added)

(iii) As an example of a profit not ordinarily being income even though it arises in the taxpayer's ordinary course of business, *Hill J.* gives the example of the sale of a taxpayer's premises because they were too small.

The key to whether the profit from the transaction in *Hill J.*'s example is income revolves around the intention of the taxpayer at the time the site was acquired. In his example, at the time the site was acquired there was no intention or purpose of profit-making by sale when the premises became too small.

*Hill J.* however seems to leave the door open, he states:

The transaction of sale may be one which arises in the ordinary course of the taxpayer's business, but that profit will not ordinarily be income, particularly where, at the time of the acquisition of the site, there was no intention or purpose of profit-making by sale when the premises became too small. (emphasis added).

It appears by the use of the word "particularly" his Honour envisages that a profit may not be income because of some other factor or circumstance even if there is an intention to make a profit by sale at the time an item is acquired. What if there is more than one intention at the time of acquisition? Would the dominant purpose prevail?

Following from the above *Hill J.* refers to the point made in *Spedley*:

.... that the purpose of profit-making must exist in relation to the particular operation. In a case where the transaction, which gives rise to the profit, is itself a part of the ordinary business (eg a profit on the sale of shares made by a share trader), the identification of the business activity itself will stamp the transaction as one having a profit-making purpose.<sup>18</sup>

This is reflected in the Australian and New Zealand income tax legislation. In New Zealand section 65 (2)(a) makes all business profits assessable.

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<sup>17</sup>Ibid., p. 4130.

<sup>18</sup><sup>91</sup> A.T.C. 4234 at p. 4242.

Similarly, where the transaction is an ordinary incident of the business activity of the taxpayer, albeit not directly its main business activity, the same can be said. The profit-making purpose can be inferred from the association of the transaction of purchase and sale with that business activity.<sup>19</sup>

His Honour cited various insurance company and bank cases as examples, in particular *London Australia Investment Co. Ltd. v. F.C. of T.*<sup>20</sup> In the case of these businesses, generally the sale of shares is a normal operation in the course of their business operations. In *London Australia* "it was an integral part of the taxpayer's business to deal in shares." per *Hill J.*<sup>21</sup>

Basically where there is some nexus between the transaction and the main business activity, a profit-making purpose can be inferred from the carrying on of that business activity. The closer the nexus the stronger the inference that the profit-making purpose exists.

*Hill J.* then looked at the business activity of Westfield. Westfield's activity did not involve the resale of land it had purchased except where the land was sold on a sale and lease back financing basis, which according to his Honour would presumably not produce a profit. The business activity of Westfield was the construction of shopping centres and their leasing or management whether it be on their own land, another parties or land owned in a joint venture. The resale of land was not part of Westfield's ordinary business activity "or, for that matter, a necessary incident of that business activity."<sup>22</sup>

It is evident from the above discussion that it is extremely important that the business activity of a taxpayer is correctly discerned by any court.

*Hill J.* referred to the judgment of *Sheppard J.* who had held that the "whole of the transaction", which *Hill J.* believed meant the transaction of purchase and sale, was carried out in the ordinary course of Westfield's business and was part of an overall profit-making scheme.

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<sup>19</sup>*Ibid.*, p. 4242.

<sup>20</sup>77 A.T.C. 4398.

<sup>21</sup>91 A.T.C. 4234 at p. 4242.

<sup>22</sup>*Ibid.*, p. 4242.

Mr Justice *Hill* stated if *Sheppard J.* was suggesting "that the transaction was one done in the ordinary course of business, his Honour fell into error, by viewing the matter temporally, contrary to the warning in *Spedley*."<sup>23</sup> The suggestion that the business of Westfield concerned the resale of land at a profit would have been contrary to *Sheppard J.*'s findings of fact, *Hill J.* stated.

(c) Income in Accordance with the Ordinary Concepts of Mankind? As the buying and selling of the land which produced the profit was not an activity in the ordinary course of business or of some other business activity, *Hill J.* stated that the profit would only be assessable by virtue of it being 'income in accordance with the ordinary concepts of mankind' if Westfield had a purpose of profit-making at the time the land was acquired.

*Hill J.* looked at the phrase "profit-making" in this context. *Sheppard J.* believed there was a scheme of profit-making being (in the words of *Hill J.*) "a scheme to achieve participation in the development of a shopping centre."<sup>24</sup>

Mr Justice *Hill* rejected this on the basis:

(i) Obtaining the contract to construct the centre and to manage it was not of itself a scheme of profit-making, rather a scheme to derive assessable income, (by performing the work under the construction and management contracts).

(ii) Where a transaction is not within the ordinary scope of the business so it is not part of that business, "there must exist, in my opinion, a purpose of profit-making by the very means by which the profit was in fact made."<sup>25</sup> This was implicit in the Full High Court judgment in *Myer*, *Hill J.* stated.

His Honour stated that *Steinberg v. F.C. of T.*<sup>26</sup> was a case (of which *Westfield* was not) where the taxpayer had the purpose or intention to make "a profit by turning an asset to account", although the means to generate the profit had not

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<sup>23</sup>Ibid., p. 4242.

<sup>24</sup>Ibid., p. 4243.

<sup>25</sup>Ibid., p. 4243.

<sup>26</sup>73 A.T.C. 4030.

been determined. In *Steinberg* the taxpayer having obtained an option to purchase land, caused a company to be incorporated with the shareholders including his family and himself. The taxpayer intended to make a profit in the most advantageous way, whether by sale of the shares in the company or by an in specie liquidation and sale. The latter course was taken.

The profit was held to be assessable under the second limb of section 26(a) of the Australian Act. The Court in *Steinberg* affirming Mr Justice *Mason* at first instance, held in this regard, that it was unnecessary that every step culminating in the making of the profit be planned or foreseen. In the words of *Mason J.*:<sup>27</sup>

In a business transaction of this kind where property is acquired with the intention that a profit should be made out of its anticipated appreciation in value by whichever means prove most suitable, it matters not that the particular means by which the profit is to be made are left for subsequent decision.

After citing this passage, *Hill J.* goes on to refine it. While a scheme can be a profit-making one despite lack of detail, "...the mode of achieving that profit must be one contemplated by the taxpayer as at least one of the alternatives by which the profit could be realised."<sup>28</sup>

He continued that it would be difficult to conceive of a case where a taxpayer was held to have made a profit from the carrying on, or carrying out of a profit-making scheme by buying and then reselling land where, at the time of acquisition, no purpose of resale was present, only the possibility that the land may be resold, the possibility of resale, *Hill J.* observed, being present in every land purchase.

The obvious example that comes to mind is where land acquired is subsequently compulsorily acquired by a local council, for example in the *Moana Sand* case. Generally when the land is acquired there will be no purpose of making a profit from a compulsory acquisition.

The same applied to section 25(1). The Court observed in *Myer* that property from which a gain is generated must be acquired in the operation of business or commercial transaction "... for the purpose of profit-making by the means giving rise

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<sup>27</sup>73 A.T.C. 4047.

<sup>28</sup>91 A.T.C. 4234 at p. 4243.

to the profit."<sup>29</sup>(emphasis added by *Hill J.*)

*Hill J.* drew further support for his decision from the case *Jennings Industries Ltd. v. F.C. of T.*<sup>30</sup>

As a result, Westfield's appeal was allowed. The Commissioner sought leave to appeal to the High Court, but his application was rejected.

(5) Conclusion

(a) Although a profit or gain made in the ordinary course of carrying on a business constitutes income, it does not follow from the *Myer* decision that every profit made by the taxpayer in the course of its business activity will be of an income nature. Such a proposition would eliminate the distinction between an income and a capital profit. The profit-making purpose must exist in relation to the particular operation.

(b) The resale of land was not part of Westfield's ordinary business activity or a necessary incident thereof, contrary to the finding of *Sheppard J.* in the Court below. Westfield's business activity was the construction of shopping centres, their leasing or management on their own land, on another's land or on land that was owned by a joint venture. *Hill J.* in so deciding is taking a narrow view of *Myer* and the concept of business. A similar view was taken in *Spedley*. This is the real importance of this decision.

(c) Where a transaction occurs outside the scope of ordinary business activities, it is necessary to find that the transaction is "commercial" and, at the time the transaction is entered into, the intention or purpose of profit-making. This purpose must exist in relation to the particular operation by which the profit is in fact made and not simply in a temporal sense. When Westfield acquired the land its preference was not the resale of the land to A.M.P. but to develop the land itself. Accordingly Westfield lacked the necessary profit-making purpose at the time of acquisition.

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<sup>29</sup>*Ibid.*, p. 4243.

<sup>30</sup>84 A.T.C. 4288.



5. *F.C. of T. v. G.K.N. KWIIFORM SERVICES PTY. LTD.*<sup>1</sup>

(1) Introduction

This was an appeal by the Commissioner from a decision of *Foster J.* It was heard in the Full Federal Court, Sydney, before *Davies, Beaumont* and *O'Loughlin J.J.* In this case a broader interpretation of *Myer* and the business concept was taken.

(2) The Facts

The taxpayer was in the business of hiring scaffolding equipment out to users in the building industry. The scaffolding held and hired by G.K.N. was plant and was treated as such by them. This was accepted by the Commissioner.

An associated company handled the sale of scaffolding components to purchasers in the building and related industries. It also sold scaffolding to other companies in the group including the taxpayer.

The issue in the case arose from the fact that there was, in the words of *Davies J.*, "a regular leakage of scaffolding" which was the result of the failure of hirers to return all the amounts hired. When scaffolding was not returned at the conclusion of the hire period, in addition to the hiring fee, the hirer was liable to pay compensation for the items not returned. Each hiring agreement contained a clause in or to the effect that: "...on termination of hire the hirer shall forthwith pay to the Company an amount sufficient to cover all losses at the then current list price for such lost items and any other costs and expenses which the Company may incur as the result thereof", known as "chargeable losses".

In the relevant income years the amounts received under this clause were 5.71%, 3.26% and 3.25% respectively of the total receipts of the taxpayer's business.

Current list prices were charged for non-returns, being those prices charged by its associated company that sold scaffolding equipment. As those prices increased over the years, the compensation received resulted in profits being the excess over the

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<sup>1</sup>91 A.T.C. 4336.

cost of the lost scaffolding.

The issue in the appeal was whether the profits were assessable revenue as contended by the Commissioner or capital profits as contended by the taxpayer.

(3) Davies J

(a) Preliminary Comments. After stating the facts, his Honour noted that evidence was called that the clause was inserted to impose a stiff penalty encouraging the return of all items of equipment hired and not with a view to making a profit.

His Honour said however that it was equally true that by including the clause in the contracts of hire, and the clause's implementation when items were not returned, had the inevitable and known consequence that the compensation received for non-returns would exceed the cost price to the taxpayer of the goods that were hired.

The taxpayer could have charged the cost price for the items not returned, it did not have to make a profit. If it had charged the cost price no part of the compensation received would have been treated as income. A reason for G.K.N. choosing to make a profit was by doing so short-returns were discouraged. In deciding whether the profit was assessable, the reason why a businessman wishes to make a profit is irrelevant. "What is important under s. 25(1) of the Act is whether the profit derived was a regular and ordinary incident of the carrying on of the business undertaking."<sup>2</sup>

(b) The Business of the Taxpayer. His Honour made reference to the *Memorex* case.<sup>3</sup> The present case he said was clearer than *Memorex* in which the taxpayer was unsuccessful.

*Memorex* concerned a taxpayer who carried on a business of selling outright computer equipment. It also leased equipment to its customers. Sometimes at the end of the leases it sold the goods to the customer. At other times it leased the goods again and sometimes it scrapped or sent them overseas to an associated company. It

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<sup>2</sup>*Ibid.*, p. 4338.

<sup>3</sup>*Memorex Pty. Ltd. v. F.C. of T.* 87 A.T.C. 5034.

was held that the profits on the sale of the equipment were income in ordinary concepts.

*Davies J.* in respect of the case before him said there was "no doubt that what occurred was a regular and ordinary incident of [the taxpayer's] business." The making of a profit as a result of the enforcement of the compensation clause was a regular incident of the taxpayer's business of hiring out scaffolding.

*Davies J.* quoted from the judgment of the High Court in *F.C. of T. v. The Myer Emporium Ltd.*:<sup>4</sup> "Because a business is carried on with a view to profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income".

(c) Capital Profits? Counsel for the taxpayer stated that the sums that were received on the short-returns were capital being compensation for the loss of scaffolding which in the hands of G.K.N. was a capital asset.

*Davies J.* however stated: "But it is not sufficient to show that the cause of the receipts was the non-return of plant." He turned to the statement of the High Court in *G.P. International Pipecoaters Pty. Ltd. v. F.C. of T.*:<sup>5</sup>

'But it cannot be accepted that an intention on the part of a payer and a payee or either of them that a receipt be applied to recoup capital expenditure by the payee determines the character of a receipt when the circumstances show that the payment is received in consideration of the performance of a contract, the performance of which is the business of the recipient or which is performed in the ordinary course of the business of the recipient.'

And so, in the present case, it is crucial that the non-return of scaffolding was a regular expected and ordinary incident of [GKN's] business and that the profits derived therefrom.

In support of this his Honour referred to *B.P. Australia Ltd. v. Commr. of Taxation of the Commonwealth of Australia*.<sup>6</sup> He concluded by noting the distinction between receipts or outgoings on revenue account and those on capital account as

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<sup>4</sup>87 A.T.C. 4363 at p. 4366.

<sup>5</sup>90 A.T.C. 4413 at p. 4422.

<sup>6</sup>[1966] A.C. 224.

enunciated by *Dixon J.* in *Sun Newspapers Ltd. v. F.C. of T.*<sup>7</sup>

His Honour had said:

The distinction between expenditure and outgoings on revenue account and on capital account corresponds with the distinction between the business entity structure or organization set up or established for the earning of profit and the process by which such an organisation operates to obtain regular returns by means of regular outlay, the difference between the outlay and the returns representing profit or loss.

In the case before him, *Davies J.* held the profits made by G.K.N. from short-returns were not of a capital nature in this sense. "The profits did not go to the business structure or entity but were a part of the regular returns resulting from the manner in which Services [G.K.N.] operated its business."<sup>8</sup>

*Davies J.* did not comment on what the structure of the taxpayer was if it was not the equipment that it hired out. If the structure of the entity was something other than the hire equipment, why did the Commissioner accept that the "sales off hire" were not income. ("Sales off hire" refers to the sale of stock on hire to a customer, at the request of the customer. This rarely happened.)

Petroulias and Kenna<sup>9</sup> suggest that the only possible distinction is that the "sales off hire" were outside the contract of hire. It was the hire contract that defined the scope of the business. It may also be that such sales were rare. It was GKN's general policy not to sell stock.

Petroulias and Kenna also comment to effect:

It is, nonetheless, curious to regard replacing equipment which does enlarge a customer's choice of equipment offered for hire as not enlarging 'the business structure of profit-yielding or income-producing asset.' The equipment is the means of making the profits rather than profit-making itself.

(d) The Lack of Intention. In holding that the making of a profit as a result of the enforcement of the compensation clause was a regular incident of the taxpayer's business of hiring out equipment, *Davies J.* discounts the lack of intention

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<sup>7</sup>(1938) 5 A.T.D. 87.

<sup>8</sup>91 A.T.C. 4336 at p. 4339.

<sup>9</sup>Petroulias and Kenna, *Revenue Expansion: Income Concepts in the Post-Myer Era Part 1: The Reach of the Doctrines*, (1992) 26 Taxation in Australia, No. 7, p. 369.

to profit from the compensation paid. Instead the receipts were income because they were a regular and ordinary incident of the taxpayer's business. It was vital for the reasoning of his Honour to find this as the taxpayer had no profit-making intention. The evidence that was called was that the clause was inserted not with the view to making a profit but to impose a stiff penalty to encourage the return of the equipment and discourage the non-return of hired equipment.

His Honour referred to *G.P. International Pipecoaters* as support for the proposition that an intention to apply a receipt to recoup capital expenditure will not determine the character of a receipt when the payment is received in consideration of the performance of a contract, the performance of which is the business of the recipient or which is performed in the ordinary course thereof.

Petroulias and Kenna comment:<sup>10</sup>

There is a conceptual difficulty in regarding Kwikform as receiving the compensation receipt in the performance of the hire contract. Kwikform performed its part by supplying the goods in the first place. There is no further performance to be done by Kwikform to which to attribute the compensation for the lost equipment. (emphasis added)

This is correct. The payment on the short-return of hired equipment was as a result of the failure of the person hiring the equipment to return all or some of it. In essence the compensation payments were made when the other party to the hire contract failed to totally perform its part of the contract.

(4) Beaumont J.

(a) His Honour's View. In his judgment, Mr Justice Beaumont focused on the applicable paragraph in the hiring agreement of G.K.N. that dealt with leakage.

*Foster J.*, the primary judge, had believed the payment made pursuant to the hiring agreement was "a forbearance from suing for the return of the goods or their value." The equipment *Foster J.* stated was part of the taxpayer's profit-earning capital. The regularity of the receipt did not give the profits an income quality.

*Beaumont J.* did not accept the analysis of *Foster J.* He referred to "[t]he general test in this area" as enunciated by the High Court in *G.P. International*

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<sup>10</sup>Ibid., p. 369.

*Pipecoaters Pty. Ltd. v. F.C. of T.*<sup>11</sup> as follows:

To determine whether a receipt is of an income or of a capital nature, various factors may be relevant. Sometimes, the character of receipts will be revealed most clearly by periodicity, regularity or recurrence; sometimes, by the character of a right or thing disposed of in exchange for the receipt; sometimes, by the scope of the transaction, venture or business in or by reason of which money is received and by the recipient's purpose in engaging in the transaction, venture or business. The factors relevant to the ascertainment of the character of a receipt of money are not necessarily the same as the factors relevant to the ascertainment of the character of its payment.

His Honour stated while the amount payable under the hire agreement was fixed by reference to G.K.N.'s current selling price, that paragraph relating to the compensation did not constitute an agreement for the sale of the equipment. On the contrary the provision proceeds upon the basis that the equipment has been lost or destroyed. His Honour said accordingly the provision operated "as a liquidated damages clause inserted in the hiring agreement, as a genuine pre-estimate of the damage suffered by GKN from time to time, when its equipment is not returned to it."<sup>12</sup> (emphasis added)

It therefore followed that the true character of the amounts G.K.N. received were a receipt of an additional fee payable as part of the total consideration given by the customer for hiring the goods.

If, as I think, GKN received an amount in the nature of an additional hiring fee to compensate it for breach of the customer's obligation to return the equipment, it must follow that the receipt of this amount is income: it has the same revenue character, in essential respects, as the hiring fees themselves.<sup>13</sup>

(b) Submissions of the Taxpayer. The taxpayer had submitted that the receipt from the chargeable losses, including the profit element, was a capital receipt in their hands, in that what G.K.N. provided in return for any such sum was a capital asset, that is, part of its income-earning plant. This approach involved treating such transactions as the loss of goods and the recompense by way of payment of the retail price for the item as being, in effect, a notional sale of a capital asset for

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<sup>11</sup>90 A.T.C. 4413 at p. 4420.

<sup>12</sup>91 A.T.C. 4336 at p. 4342.

<sup>13</sup>Ibid., p. 4342.

a contractual price. A similar approach was taken in *F.C. of T. v. Cyclone Scaffolding Pty. Ltd.*<sup>14</sup>

The same result it was argued would be achieved if the payment under the contract were regarded as, in effect, a pre-estimate of damage for the conversion by the hirer of the taxpayer's goods, a judgment in conversion would have the effect of transferring the title in these goods to the converter, the hirer.

In either case the consideration for the payment would be the transfer of the title in the goods owned by the taxpayer. Those goods were income-producing and accordingly a capital asset. The receipt of the compensation money would accordingly also be on capital account.

(c) The Correct View? The submissions of the taxpayer are with all respect the more correct view of the character of the payments the taxpayer received. An income-producing asset is not returned to G.K.N. Accordingly the money (compensation) received for the loss of that capital asset will be on capital account.

The payment is not an additional hiring fee. It is not paid on the hire of the equipment but on its non-return. Rather as stated by *Foster J.*, the consideration provided by the taxpayer was "a forbearance from suing for the return of the goods or their value."

Before *Foster J.* in the Federal Court, the Commissioner taking a broad view of the hire contracts argued that any payments received under the hiring agreement were received for hiring out its equipment. The Commissioner argued: "Such payments include compensatory payments for loss or non-return under the contracts. Being moneys received in consideration of the hiring of the equipment, they necessarily bear an income character."<sup>15</sup>

His Honour had not agreed with the Commissioner.

I do not think it appropriate to view these contracts of hire in such a broad way. When examined closely, it is clear that they distinguish between receipts which are properly described as hiring charges for the equipment and payments received under the clauses providing for compensation. Quite clearly a different

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<sup>14</sup>87 A.T.C. 5083.

<sup>15</sup>*G.K.N. Kwikform Services Pty. Ltd. v. F.C. of T.* 90 A.T.C. 4823 at p. 4834.

character is accorded to the compensation payment from that attributed to their hiring charges. Where there is a relevant non-return, the hiring charges are to continue until the compensatory payment is made. This clearly accords, in my view, with the conception that the hiring charges are attributable to the use by the customer under the contract of the applicant's capital asset whilst the compensatory payment relates not to its use but to the fact that the customer has deprived the applicant of it.<sup>16</sup>

In support of the payments on non-return being of a capital character, as already noted the profits from "sales off hire" were accepted by the Commissioner as non-assessable capital receipts. Such sales were however rare. Perhaps a distinction can therefore be made between profits from these sales and the "chargeable losses" on the basis of the regularity of the type of receipt. However even on this point, the amount received from the "chargeable losses" in the years in question was between 3.25% and 5.71% of the total receipts of the taxpayer. These receipts although regular and recurrent were only a small proportion of the total receipts of the taxpayer.

Another way of looking at the receipts may be that as a result of the contract's operation, on the non-return of hired equipment, the equipment is converted into trading stock that is to be compulsorily purchased by the customer at a profit for the taxpayer.

(d) Additional Comments by Beaumont J. His Honour did not consider it necessary to consider what the position might have been if instead of the liquidated damages clause, GKN had contracted for the sale to the hirer of the equipment. He considered the provision, both in substance and form, could not be described as an agreement for sale, whether expressly or by implication. On a particular contingency, being the loss or the destruction of the equipment, an additional sum or fee was payable by the hirer. The payments should therefore be treated as in the nature of an extra hiring fee and therefore income.

Petroulias and Kenna<sup>17</sup> believe however that the implication from the judgment of *Beaumont J.* is that if there had been inserted in the contract a clause to

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<sup>16</sup>Ibid., p. 4834.

<sup>17</sup>Petroulias and Kenna, *Revenue Expansion: Income Concepts in the Post-Myer Era. Part 1: The Reach of the Doctrines*, (1992) 26 *Taxation in Australia*, No. 7, p. 369.



the effect that there was a deemed sale at the contractual price on the non-return of the goods, there might have been the sale of a capital asset. On the contrary, they believe such a clause would be more likely to attribute an income character rather than a capital character, whatever might have been the capital status of the equipment at the time it was hired.

His Honour agreed with *Foster J.* that the *Memorex* and *Cyclone* cases were distinguishable "on their own rather special facts."

(5) *O'Loughlin J.*

*O'Loughlin J.* also believed the sums in question were of a revenue nature.

(6) Conclusion

The Full Federal Court upheld the appeal by the Commissioner. While the reasons of *Davies* and *Beaumont J.J.* differ, both judges viewed the profit from the non-returned equipment as forming an incident of the business of the taxpayer.

(a) *Davies J.* discounted the taxpayer's lack of intention to profit from the compensation receipts. He saw the receipts for the non-return of scaffolding as income because they were a regular, expected and ordinary incident of the taxpayer's business of hiring out scaffolding. It was crucial that he found this in view of the taxpayer's lack of profit-making intention. By so holding his Honour took a broad interpretation of the decision of the High Court in *Myer* and what formed part of the taxpayer's business. The profits were not capital in nature because they did not go to the business structure or entity. Rather they were part of the regular returns that resulted from the manner in which G.K.N. operated the business, per *B.P. Australia* and the *Sun Newspaper* case.

(b) *Beaumont J.* saw the amounts received under the compensation clause as an additional hiring fee that was payable in a particular contingency in order to compensate G.K.N. for the breach of the customer's obligation to return the equipment. It was part of the total consideration given by the customer for the hire of the goods. Accordingly, the amounts received were income having the same revenue character as the hiring fees themselves.

6. *HENRY JONES (IXL) LTD. v. F.C. of T.*<sup>1</sup>

(1) Introduction

This was an appeal by Henry Jones from the decision of *Sweeney J.* There are one or two parallels with the facts of the *Myer* case. The decision itself was delivered some four years after the *Myer* decision.

(2) The Facts

Henry Jones (IXL) was a holding company of a number of subsidiaries that carried on the business of producing and marketing canned fruit. It owned the labels and trade marks under which the canned fruit was marketed. The taxpayer decided to sell the business as it did not meet its 20% profitability requirement.

The taxpayer entered into negotiations with S.P.C. Ltd. ("S.P.C.") and Ardmona Fruit Producers Co-operative Co. Ltd. ("Ardmona") to sell its canned fruit business. The taxpayer wanted to obtain a lump sum payment and to exit from the canned fruit industry. However S.P.C. and Ardmona required that any purchase monies paid to acquire the business be tax deductible.

The parties entered into a licence agreement in December of 1981 whereby S.P.C. and Ardmona were granted the right to use the taxpayer's labels anywhere in the world in relation to both the production and marketing of canned fruits for the period of ten years. As consideration S.P.C. and Ardmona agreed to pay the taxpayer in each year during the ten year term a royalty equal to 5% of the net value of sales of canned fruits sold under the labels subject to a guaranteed minimum royalty over the ten years totalling \$12,500,000. Upon the expiry of the licence agreement the labels were to revert to a company that was related to the taxpayer.

The taxpayer subsequently assigned all its rights under the licence agreement to Citicorp Canberra Pty. Ltd. for a lump sum of \$7,581,691 in May 1982. It thus received a lump sum as it had originally desired and was able to leave the industry.

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<sup>1</sup>91 A.T.C. 4663.

The Commissioner included the sum of \$7,581,691 received for the assignment as assessable income. The taxpayer's objection was disallowed so the taxpayer appealed to the Federal Court on the basis that the sum received was capital. The appeal was heard before *Sweeney J.* in the Federal Court.<sup>2</sup>

In the Federal Court, his Honour applied the reasoning of the High Court in *F.C. of T. v. Myer Emporium Ltd.*<sup>3</sup> *Sweeney J.* found the lump sum payment was assessable income of the taxpayer as:

(a) Henry Jones had entered into the licence agreement for the purpose of profit-making by sale in the context of carrying on a business; and

(b) The effect of the assignment of the right to royalties was to convert future income into present income.

(3) The Full Federal Court

The taxpayer appealed the decision. The appeal was heard in the Full Federal Court before *Jenkinson, Hill and Heerey J.J.* *Hill J.* gave the main judgment.

(a) The Myer Case. Before setting out the basis for his judgment *Hill J.* referred to the High Court decision of *F.C. of T. v. Myer Emporium Ltd.* He identified the two strands of thought in the case.

To recapitulate, the first strand is that a receipt may constitute income if it arises from an isolated business operation or commercial transaction that is entered into otherwise than in the course of the carrying on of the business of the taxpayer, so long as the taxpayer entered into the transaction with the purpose of making a relevant profit or gain from that transaction.

The second strand of the decision is that the assignment/sale of a mere right to interest, severed from the underlying property that is the source of the income, is itself income.<sup>4</sup>

If the lender sells his mere right to interest for a lump sum, the lump sum is

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<sup>2</sup>*Henry Jones (IXL) Ltd. v F.C. of T.* 91 A.T.C. 4119.

<sup>3</sup>87 A.T.C. 4363.

<sup>4</sup>*Ibid.*, p. 4371.

received in exchange for, and ordinarily as the present value of, the future interest which he would have received. This is a revenue not a capital item - the taxpayer simply converts future income into present income...

(b) The Submissions. The appellants submitted the first strand had no application as there was no profit-making purpose and *Sweeney J.* at first instance had not found an intention. Further there had been no profit, unlike in *Myer's* case. The second strand had no application because in the present case, again unlike the *Myer* case the whole of the relevant property (the benefit of the licence agreement) was assigned.

The Commissioner submitted that the *Myer* case was indistinguishable. Two alternative submissions were made to the effect that the amount received in the transaction took place in the ordinary course of the appellants' business.

(c) The First Strand - Purpose or Intention to Make a Profit. *Hill J.* noted there may be a fine distinction between purpose and intention, both words being used by the High Court in *Myer*. His Honour found it unnecessary however to determine whether there was a distinction of substance between the two concepts as their Honours in the High Court had used them interchangeably.

His Honour did not believe that Henry Jones had entered into the licence agreement with the purpose of making a profit by assigning its rights under the licence agreement. The licence agreement had been entered into for the commercial purpose of enabling the group to exit from the canned fruit industry.

While it must be accepted that in entering into the licence agreement the appellant did so with the intention of thereafter assigning the benefits of it to a bank or finance house, it would seem a misleading half-truth to say that its purpose of entering into the licence agreement...was to realise the amount which it ultimately obtained from Citicorp.<sup>5</sup>

Surely the argument is little different from the *Myer* case. The taxpayer in *Myer* had the purpose of obtaining additional working capital. It lent the funds with the intention of assigning the right to interest. This was however not its purpose for entering the transaction. Perhaps there is an important difference between "purpose" and "intention" which the decisions have not emphasised.

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<sup>5</sup>91 A.T.C. 4663.

In addition despite stating that it was unnecessary to determine whether there was a distinction of substance between the concepts of "purpose" and "intention", in the above cited passage he appears to be drawing a distinction between the two concepts.

In this part of his judgment his Honour also discusses whether there was a profit and if so whether it was derived progressively over the term of the agreement or in the year of income.

In respect of profit, his Honour referred to the High Court decision of *F.C. of T. v. Becker*<sup>6</sup> where the taxpayer transferred land owned to a company in return for shares in order to circumvent price control regulations. Subsequently the shares in the company were sold for a higher figure than that paid by the company for the land.

*Hill J.* quoted from the judgment of *Kitto J.* in the case: "a profit is not found to have arisen until there has been deducted from the ultimate sum received the amount or value of all that in fact it has cost the recipient to obtain that ultimate sum."

His Honour also discussed the accounting treatment of a trademark and royalty agreement.

He concluded however it unnecessary to pursue these issues as he believed unlike the taxpayer in *Myer* the licence agreement was not entered into with the purpose of making a profit by the sale of it.

This finding of *Hill J.* was contrary to that of *Sweeney J.* in the Court below. *Sweeney J.* had:<sup>7</sup> "no hesitation in drawing the inference that before it [Henry Jones] entered into that deal [with Ardmona and SPC] it had decided that it would assign its rights under it to a bank or financial house in return for a lump sum payment."

(d) The Second Strand: *Myer* Revisited. *Hill J.* noted that the High Court in the *Myer* case distinguished the case of a right to interest income on an underlying debt from that of a right to be paid an annuity under an annuity contract.

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<sup>6</sup>(1952) 10 A.T.D. 77.

<sup>7</sup>91 A.T.C. 4119 at p. 4140.

To recapitulate, their Honours in *Myer* stated that a covenant to pay interest may be independent of or accessory to a covenant to repay the principal sum or the two covenants may be integral parts of a single obligation:

...but it is of the essence of interest that it be referable to a principal sum: per *Rand J.* in *Reference as to the Validity of Section 6 of the Farm Security Act, 1944, of the Province of Saskatchewan* (1947) S.C.R. 394 at pp. 411-412. The source of interest is never the mere covenant to pay. Interest is not like an annuity. Annuity payments are not derived from the money paid for the annuity; they are derived solely from the annuity contract. And so, when a contractual right to be paid an annuity is sold for a price, the proceeds of sale are ordinarily capital in the hands of the vendor: *Paget*, at pp 35, 44-45;...The vendor receives the price in exchange for a capital asset - the contractual right which produces payment of the annuity. If a lender who sells a right to interest severed from the debt were regarded as disposing of an income-producing right, *Paget* would indicate that the price should be treated as capital. But the contractual right is not the source of the interest to which it relates: a contractual right severed from the debt is not the structure which produces that income.<sup>8</sup>

If a lender sells for a lump sum his mere right to interest, the lump sum is received in exchange for the future interest he would have received, the lump sum ordinarily being the present value of the future interest. Such is revenue as the taxpayer simply converts future income into present income.

The High Court distinguished *I.R. Commrs. v. Paget*<sup>9</sup> on the basis that the facts in *Paget* were different from those in *Myer*.

(e) The Present Case. In reference to the second strand, *Hill J.* said:<sup>10</sup>

The difficult question is whether in *Myer* the High Court was propounding a view of the law that the assignment of every right to receive income in the future, other than a right arising under a contract dissociated from any other underlying property from which the income may be said to be derived, results in the consideration for the assignment being of a revenue nature as being in substitution for the income that would otherwise have been derived, or whether the decision was intended to be more narrowly confined. (emphasis added)

Before answering the question, his Honour noting the obvious distinction between royalties and interest turned to discuss the nature of a trademark and more generally an industrial property right. A trademark can generate income directly by

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<sup>8</sup>87 A.T.C. 4363 at 4371.

<sup>9</sup>(1938) 2 K.B. 25.

<sup>10</sup>91 A.T.C. 4663 at p. 4673.

use in a business of manufacturing or selling or by licensing others to use it. The consideration paid for a licence may be made in a lump sum or by way of royalties.

His Honour deals with the various tax treatments of periodic royalties (income) and lump sum payments, distinguishing between the rights granted.

He makes two points. His first point is that, without more, the mere industrial property right that is licensed does not generate income. The income is generated when the right is turned to account by, for example, licensing another to use the right. While "no income could be generated without the ownership or other relevant interest in the industrial property right, the right to income in the form of royalties is more immediately derived from the licence agreement itself."<sup>11</sup>

Interest however may be said to be more immediately derived from the lending out of the principal, the interest being the price that is payable to the lender for that person being without their money for the loan term. When however a loan is made and in return a lender obtains a chose in action for the repayment of those moneys, that chose does not itself generate any interest covenanted to be paid.

The second point to be noted is that had S.P.C. and Ardmona been licensed to use the trademarks in consideration for a lump sum which was calculated by reference to the present value of the anticipated user of the trademarks, in accordance with English cases his Honour had earlier referred to, the lump sum would be capable of being seen as income.

*Hill J.* answers the question he posed at the beginning of this section concerning the scope of the *Myer* decision in respect of the assignment of a right to receive income (at p. 4675):

Notwithstanding some doubt, I think *Myer* must be taken as establishing that, except in the case of the assignment of an annuity where the income arises from the very contract assigned, an assignment of income from property without an assignment of the underlying property right will, no matter what its form, bring about the result that the consideration for that assignment will be on revenue account, as being merely a substitution for the future income that is to be derived. Thus, the fact that the future income may be secured by an agreement, and that the assignment is of the right title and interest of the assignor in that agreement will not affect the result.

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<sup>11</sup>*Ibid.*, p. 4674.

As Richard Edmonds<sup>12</sup> points out the appellant could not have been surprised at *Hill J.*'s answer given his Honour's statement some four years before, albeit in a different capacity. Graham Hill in 1987 stated:

It is interesting that while the judgment [in *Myer*] distinguishes *Paget's* case it also takes the opportunity to establish as a principle that the assignment of interest income will always result in the consideration being income. Whether the same result would follow if what was assigned was a rent stream or a royalty stream the Court did not need to consider. However it might be difficult in principle to distinguish these cases from the assignment of interest in *Myer*. One could not say that the sale of a right to royalty income, for example, severed from the contract which produced it was a sale of a tree of which the future payments were the fruit. Nor would it seem that this could be said any more of rent. Thus it would seem that *Myer's* case may stand for a proposition that, with the exception of the sale of an annuity, the sale of any income stream severed from that which produced it will result in the derivation of income.<sup>13</sup>(emphasis added)

Edmonds<sup>14</sup> believes this principle established by *Myer* is correct, however the way that the Court articulated its view "suggests, with respect, that the assignment of an annuity is the only assignment which does not involve an assignment of income severed from underlying property."

While the High Court in *Myer* distinguished the case of a right to interest income on an underlying debt from that of a right to income under an annuity, Edmonds suggests that was "merely by way of example or contradistinction", and an appropriate one as the High Court was dealing with the assignment of a right to receive interest which was severed from the underlying debt to which it related. The example of an annuity exemplified the distinction because, as pointed out by the High Court, the right to receive an annuity relates solely to the annuity contract not to any underlying property. However Edmonds states that:<sup>15</sup>

The High Court in *Myer* did not, expressly or by implication, suggest that an annuity was the only case of a right to receive income which did not relevantly

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<sup>12</sup>Edmonds, *Assessable Income: Unravelling the Second Strand*, (1992) 26 *Taxation in Australia*, No. 11, p. 618.

<sup>13</sup>Hill, *A Pre-Bicentennial Reminder of our Heritage: Commissioner of Taxation v. The Myer Emporium Ltd.*, (1987) 22 *Taxation in Australia*, No. 1, p. 17.

<sup>14</sup>Edmonds, *Assessable Income: Unravelling the Second Strand*, (1992) 26 *Taxation in Australia*, No. 11, p. 618.

<sup>15</sup>*Ibid.*, p. 618.



relate to underlying property. Nor should it be given this status by the manner in which the Federal Court articulated the principle in *Henry Jones (IXL)*.

Edmonds notes the Commissioner's statement in the draft ruling *E.D.R. 72* at para. 54 closely follows the wording of the Federal Court. The Commissioner states that except for an assignment of annuity income, an amount that is received for the transfer of a right to a stream of income severed from the property to which it relates will be income according to ordinary concepts.

Edmonds<sup>16</sup> notes two situations where an income stream which is not an annuity is sourced solely in contract and not from some underlying property. The first is an author who after selling the copyright in a work to a publisher in consideration for a royalty stream based on the number of books sold, assigns for a lump sum his right, title and interest to receive the royalty stream to an assignee. The author's right to receive a royalty stream as with an annuity is sourced solely in the contract for the sale of copyright. Based on this characterisation the lump sum received falls, he submits, into the "annuity exception" and is received on capital account.

The second example he gives is of an investor who acquires an overriding royalty that is based on the amount of ore that is won from the ground, and is unrelated to the tenement from which the ore is extracted. The investor does not acquire or otherwise hold any interest in the underlying tenement. The investor's right to receive the royalty is sourced solely in contract. As examples he compares the Weekes' royalties payable in respect of the ore won from the B.H.P./E.S.S.O. Bass Strait oil tenements with the facts in *Commissioner of Internal Revenue v. P.G. Lake, Inc.*<sup>17</sup>

Edmonds also considers the assignee's position in both *Myer* and *Henry Jones (IXL)*. In both cases the assignees' right to receive the income payments was sourced not in any underlying property but in contract, being the deeds of assignment from which they acquired those rights. Such an assignment by the assignees, for a lump

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<sup>16</sup>Ibid., p. 618.

<sup>17</sup>(1958) 356 U.S. 260.

sum, of their rights to receive those payments, Edmonds submits, would also fall within the "annuity exception" and be on capital account. Such treatment of the lump sum consideration may seem anomalous when compared with the fact that the lump sum considerations received by *Myer* and *Henry Jones (IXL)* for their assignments were revenue receipts.

The explanation, however, lies in the fact that the assignments by *Myer* and *Henry Jones (IXL)* involve a carving out from the property from which the income would otherwise be derived; thus, what is assigned, to use the words of *Kitto J* in *Shepherd v FCT* [1965] 113 CLR 385, at p 396, is the 'fruit' rather than the 'tree' and what is received should be characterised as being in substitution for that 'fruit'.<sup>18</sup>

On the other hand, in the case of the assignments by their assignees, what is being assigned is the entire contractual interest that is not carved out of any other property and is, therefore, an assignment of the "tree" rather than the "fruit".

*Hill J.* follows on from his statement at p. 4675 noting the principle is consistent with the law concerning compensation for rights of income. "Amounts received as compensation for an income right, amounts which thus fill the hole of income, have the character of income."

If the general proposition needed to be qualified by restricting it to receipts in the course of business, the receipt in the case before him was, he said, gained by *Henry Jones (IXL)* in the course of its business as a holding company.

He also noted the passage in *C. of T. (Vic.) v. Phillips*,<sup>19</sup> cited in *Myer* that: "It is true that to treat a sum of money as income because it is computed or measured by reference to loss of future income is an erroneous method of reasoning." His Honour was of the view that where a chose in action is assigned by a taxpayer, being a right to receive periodical sums, which when received would be income derived from the underlying property that is retained and the taxpayer assigns that right for an amount calculated as the present value of that income stream, that consideration should be seen as much income as the stream that it replaces. This is

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<sup>18</sup>Edmonds, *Assessable Income: Unravelling the Second Strand*, (1992) 26 *Taxation in Australia*, No. 11, p. 619.

<sup>19</sup>(1936) 3 A.T.D. 330 at pp. 334-335.

notwithstanding that the consideration is paid in a lump sum rather than by periodical payments that are in substitution for the income stream.

*Hill J.* accordingly dismissed the appellants' appeal. In the circumstances there was no need to consider the Commissioner's alternative submission that the consideration paid to the appellant represented a transaction that was made in the ordinary course of business and therefore should be seen as income.

*Heerey J.* also dismissed the appeal. The purpose of the appellant in creating the licence agreement was to assign it for a lump sum. He believed, on this issue (section 26(a) of the Act) that the case was not relevantly distinguishable from *Myer*. In respect of section 26(a) his Honour believed for the reasons given by *Hill J.* that there was a profit.

In respect of the second part of *Hill J.*'s judgment he agreed with *Hill J.*'s reasoning and conclusion that the consideration for the assignment of income from property without an assignment of the underlying property right was income according to ordinary concepts and therefore within section 25(1).

*Jenkinson J.* agreed with the reasons in the judgment of *Hill J.*

#### (4) Conclusion

(a) *Hill J.* found that Henry Jones (IXL) did not enter the licence agreement with the purpose of profit-making by sale. Accordingly the first strand of the *Myer* decision was not applicable. This was contrary to *Sweeney J.*'s finding and may again indicate a narrower interpretation of *Myer* and the concept of business.

(b) The second strand of the *Myer* decision did apply. Except in the case of the assignment of an annuity, the assignment of income from property without the assignment of the underlying property right will mean the consideration for the assignment will be on revenue account irrespective of its form. It is merely a substitution for the future income that would otherwise have been derived. The lump sum was accordingly income in ordinary concepts under section 25(1) or the second limb of section 26(a).

*Hill J.* in his judgment largely follows *Myer* in this respect.

7. *F.C. of T. v. HYTECO HIRING PTY. LTD.*<sup>1</sup>

(1) Introduction

This case was an appeal by the Commissioner from the decision of *Beaumont J.* It was heard before the Full Federal Court. *Hill J.* gave judgment, *Black C.J.* and *Wilcox J.* agreeing with his decision. In his judgment *Hill J.* takes a more narrow view of what constituted the taxpayer's business than some of the earlier decisions, and drew from statements he made in the *Westfield* case.

(2) The Facts

The taxpayer carried on the business of hiring out forklift trucks to customers. It carried on no separate business of buying and selling such trucks. The forklifts were generally acquired new from two related companies, Hyteco Pty. Ltd. and Hyteco (N.S.W.) Pty. Ltd. These companies together were the distributors of the "Hyster" forklifts in three Australian states. Some forklifts were purchased outright while others were acquired by way of a lease from a financier. When the lease expired the taxpayer either purchased the forklift at its residual value or entered into a further lease arrangement with the financier. In the majority of cases at the expiration of the lease the residual value was greater than the market value of the forklift.

The taxpayer claimed depreciation on those forklifts that were purchased and hired out. When the forklift was considered to be no longer suitable for hire the taxpayer usually arranged for its sale through the used equipment division of Hyteco (N.S.W.). Except for a few exceptional cases, the taxpayer sold the forklifts shortly after it purchased them at their residual value.

The Commissioner included in the taxpayer's assessable income in the 1977, 1978, 1979 and 1983 income years amounts totalling \$584,147 which had been returned by the taxpayer as "capital profits on sale of hiring assets." The amounts were the proceeds of sales of the forklifts less their original cost or residual value. In

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<sup>1</sup>92 A.T.C. 4694.

the majority of cases the amounts were the net profits in excess of the section 59(2) balancing charge arising on the disposal of depreciated property.

*Beaumont J.* in the Federal Court held the proceeds on sale of the forklifts not to be assessable under section 25(1). The Commissioner appealed, arguing while the main business activity of the taxpayer was the leasing of forklift trucks to its customers, the sale of the forklifts when they were no longer suitable for further hiring was an ordinary incident of that business. The profits on such sales were therefore income according to ordinary concepts under section 25(1). This was the issue in the case.

(3) The Decision

(a) The Taxpayer's Business: *Californian Copper* and *Myer*. *Hill J.* cited the well known and oft quoted comments of the Lord Justice Clerk in *Californian Copper Syndicate v. Harris*<sup>2</sup> including this passage: "Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?"

*Hill J.* observed that the formulations in *Californian Copper* emphasise that a business profit will be income. However it does not follow that a non-business profit can never be income, for example, where assets sold were acquired for the purpose of profit-making, and the transaction that gives rise to the gain has the character of a business deal and is made in carrying out a profit-making scheme.

His Honour recognised the acceptance of *Californian Copper* in Australia in *London Australia*<sup>3</sup> and *Myer*.<sup>4</sup> He also noted the requirement of making, when determining whether a profit was made in the course of business, "a wide survey and an exact scrutiny of the taxpayer's activities": *Western Gold Mines N.L. v. F.C. of T. (W.A.)*<sup>5</sup>

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<sup>2</sup>(1904) 5 T.C. 159.

<sup>3</sup>*London Australia Investment Co. Ltd. v F.C. of T.* 77 A.T.C. 4398.

<sup>4</sup>*F.C. of T. v. The Myer Emporium Ltd.* 87 A.T.C. 4363.

<sup>5</sup>(1938) 59 C.L.R. 729 at p. 740.

*Beaumont J.* had after undertaking such a survey concluded the taxpayer's business was the leasing of forklifts to customers.

On the basis of the evidence *Hill J.* stated it would have been erroneous to characterise the business as both the hiring of forklift trucks and the sale of the trucks. The trucks were purchased for the purpose of leasing them out, not for resale. This was the case, notwithstanding that the sale of trucks no longer suitable for leasing was inevitable, or, at least, the only alternative to scrapping them at the end of their useful life.

(b) The Intention of the Taxpayer. *Hill J.* referred to the passage from the High Court in *Myer* including:<sup>6</sup>

...a gain made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income. Whether it does depends very much on the circumstances of the case.

In the case before him, it could not be inferred that Hyteco's intention or purpose in acquiring the trucks was to make a profit from the resale of those trucks. The profits would therefore only be income if they were made in the ordinary course of carrying on Hyteco's business.

(c) Income in the Ordinary Course of Carrying on a Business.

(i) Regularity or Magnitude of Payment. Neither the regularity nor the scale of the profits caused the profits to be income in ordinary concepts. The regularity of the receipt can often indicate that amounts have the character of income *Hill J.* observed, referring to *F.C. of T. v. Dixon*.<sup>7</sup> However this on its own will seldom be determinative of the issue. More is required, for example, an intention by the payer that the receipts be used by the recipient for regular expenditure and be relied upon by the recipient: *F.C. of T. v. Harris*.<sup>8</sup> Conversely a single payment could be income even though it is not repeated: *Smith v F.C. of T.*<sup>9</sup>

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<sup>6</sup>87 A.T.C. 4363 at pp. 4366-4367.

<sup>7</sup>(1952) 86 C.L.R. 540 at p. 557.

<sup>8</sup>80 A.T.C. 4238.

<sup>9</sup>87 A.T.C. 4742.

Regularity may be an indicator in a particular fact situation that a business is being carried on and therefore the proceeds of that business are income: see, for example, *Hope v. Bathhurst City Council*<sup>10</sup> This was not the situation before the Court.

The magnitude of the profits made will not have great relevance to their characterisation as income. His Honour quoted the example of the \$9,889,459 profits made by the taxpayer in *A.G.C. (Investments) Ltd. v. F.C. of T.*<sup>11</sup> which were held not to be income.

(ii) "in the ordinary course of business". *Hill J* commented:

As I sought to emphasise in *Westfield*, the words 'in the ordinary course of business' must be understood in their context. In particular, it does not follow from these words, as used by the High Court in *Myer*, that every gain made by a taxpayer carrying on a business and which has some relationship to that business will be taxable. To so hold would be to destroy completely the distinction between capital and income, blurred though such a distinction may sometimes be.<sup>12</sup>

This is in line with comments also made in *Spedley*<sup>13</sup> and is an important qualification to the *Myer* decision.

(iii) The Cases. His Honour looked at three recent decisions of the Court: *F.C. of T. v. Cyclone Scaffolding Pty. Ltd.*,<sup>14</sup> *Memorex Pty. Ltd. v. F.C. of T.*<sup>15</sup> and *F.C. of T. v. G.K.N. Kwikform Services Pty. Ltd.*<sup>16</sup>

In his discussion, *Hill J* quoted the passage from the judgment of *Davies* and *Einfeld J.J.* in *Memorex*:<sup>17</sup>

The applicant did not have a business in which it held standard pieces of

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<sup>10</sup>80 A.T.C. 4386 at p. 4390.

<sup>11</sup>92 A.T.C. 4239.

<sup>12</sup>92 A.T.C. 4674 at p. 4700.

<sup>13</sup>*F.C. of T. v. Spedley Securities Ltd* 88 A.T.C. 4126.

<sup>14</sup>87 A.T.C. 5083.

<sup>15</sup>87 A.T.C. 5034.

<sup>16</sup>91 A.T.C. 4336.

<sup>17</sup>87 A.T.C. 5034 at p. 5044.

equipment in stock and hired that equipment out to one customer after another. It normally supplied equipment for a particular requirement and supplied that equipment, at the customer's option, either by outright sale or by lease.

There is no analogy between this case and the case of plant or equipment that a taxpayer may have and may use as part of the structure of an enterprise. The subject goods were part of the goods in which the applicant was dealing.

*Hill J.* distinguished the case before him from *G.K.N. Kwikform* on the basis that the profit in question was not inevitable; nor did it arise as part of the actual leasing transaction. The present case was:<sup>18</sup>

...concerned with ...a profit arising on a sale to third parties of the very apparatus with which the taxpayer conducted its business, not a profit from the process by which the taxpayer operated to obtain regular returns by means of regular outlays: *cf Sun Newspapers Ltd & Associated Newspapers Ltd v FC of T* (1938) 5 ATD 87 at 93; ...*GKN Kwikform* at 4339. It is a profit of a capital nature and not a revenue profit.

*Hill J.* drew support from the New Zealand and Canadian decisions of *Rank Xerox (N.Z.) Ltd. v. C. of I.R.*<sup>19</sup> and *Anthes Equipment Ltd. v. The Minister of National Revenue*.<sup>20</sup>

(iv) An aside - The Banking and Insurance cases. In concluding his judgment he referred to the following passage in *Westfield Ltd. v. F.C. of T.*:<sup>21</sup>

In a case where the transaction, which gives rise to the profit, is itself a part of the ordinary business (eg a profit on the sale of shares made by a share trader), the identification of the business activity itself will stamp the transaction as one having a profit-making purpose. Similarly, where the transaction is an ordinary incident of the business activity of the taxpayer, albeit not directly its main business activity, the same can be said. The profit-making purpose can be inferred from the association of the transaction of purchase and sale with that business activity. The cases on profits and losses of insurance companies and banks are examples...

*Hill J.* goes on in *Hyteco* to discuss the rationale of the decisions in respect of banking and insurance businesses:<sup>22</sup>

The moneys so invested form part of the circulating capital of the business and

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<sup>18</sup>92 A.T.C. 4694.

<sup>19</sup>(1983) 6 N.Z.T.C. 61,501

<sup>20</sup>87 D.T.C. 59.

<sup>21</sup>91 A.T.C. 4234 at p. 4242.

<sup>22</sup>92 A.T.C. 4694 at p. 4703.



the investment is so integrally related to the business that it may truly be said that the act of realising those investments is an act done in the carrying on of the banking or insurance business: cf *Punjab Co-operative Bank Ltd, Amritsar v Commissioner of Income Tax, Lahore* [1940] AC 1055 at 1073. The money held by a bank or insurance company for this purpose is at least analogous to its trading stock.

It has been made clear by *Gibbs J*, as he then was, in *London Australia* (at 118) that the banking and insurance cases do not reflect a distinct and separate line of authority. They are, rather, but examples of the principle enunciated in *Californian Copper*.

He believes it is perhaps misleading to treat these cases as a separate category. His Honour suggests for example that the correct characterisation of a banking business may be both banking and investing. Irrespective of the correct characterisation of either a banking or insurance business, because the making and realising of investments is so integral to either of these businesses, a profit on the realisation of investments will form part of that particular business's income.

It is in that sense that I said in *Westfield* that the profit-making purpose inherent in the realisation can be inferred from the association of the investment activity to the main business activity. There may be examples, other than banking and insurance, where the same result follows, not as a matter of law but as a matter of fact. However, in the sense in which I used the words in *Westfield*, the sale of forklift trucks at a profit is not an ordinary incident of the business activity of a company hiring out such trucks, any more than the sale of redundant typewriters or word processing equipment is an ordinary incident of the business of a solicitor or accountant.<sup>23</sup> (emphasis added)

Is this last paragraph reference to the *Cooling* decision discussed later which concerned a lease incentive paid to a lessee who moved premises. It is arguable that moving from leased premises to other leased premises is no more an ordinary incident of the business of a solicitor than is the sale of redundant typewriters or word processing equipment.

#### (4) Conclusion

(a) By taking a narrow view of what formed part of Hyteco's business, *Hill J.* takes a narrow interpretation of the decision of the High Court in *Myer*. He found (*Black C.J.* and *Wilcox J.* agreeing) that it would be erroneous to characterise Hyteco's business as being both the hiring of forklift trucks and the sale of such

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<sup>23</sup>*Ibid.*, pp. 4703-4704.

trucks. The trucks were purchased for the purpose of leasing not resale. This was so even though it was inevitable that trucks no longer suitable for leasing would be sold. The only alternative being to scrap them. This case again illustrates the importance of correctly establishing the actual scope of the taxpayer's business.

(b) As a result of (a) the profits made would only be income if made in the ordinary course of carrying on Hyteco's business. His Honour discusses the words "in the ordinary course of business", drawing from comments he had made in the *Westfield* case. He said it does not follow from the way the phrase was used in *Myer* that every gain that is made by the taxpayer carrying on a business and which has some relationship to that business will be taxable. This would destroy completely the distinction between capital and income.

(c) The profit that was made arose from the sale of trucks that formed the apparatus by which Hyteco conducted its business. The profit did not arise from the process by which Hyteco operated to obtain regular returns by means of regular outlays. The profit was therefore of a capital nature. His Honour distinguished the *Cyclone Scaffolding*, *Memorex* and *G.K.N. Kwikform* cases.

8. ON THE OTHER HAND: *KENNEDY HOLDINGS and PROPERTY MANAGEMENT PTY. LTD. v. F.C. of T.*<sup>1</sup>

(1) Introduction

This was a decision before *Hill J.* in the Federal Court of Sydney. This case looks at the deductibility of expenditure incurred by the taxpayer rather than the assessability of a receipt.

(2) The Facts

The taxpayer was the co-owner of a property in Sydney. The property was leased to the lessee, Mark Foys Pty. Ltd., from 1978. In 1984 the lessee exercised an option to renew the lease of the premises for a further five years until 30 September 1989. There was a further option to renew for a period of five years from 1 October 1989.

In July 1988 the taxpayer and co-owner agreed to pay the lessee, the sum of \$262,500 in consideration of it vacating the premises on or before 30 September 1988. This agreement was confirmed by letter. The purpose of the payment to the lessee was to allow the co-owners to gain possession of the property so a new lease could be granted to a new tenant that would yield a higher rental return.

Under the lease to Mark Foys Pty. Ltd., rent for the period ended 30 September 1989 would have been \$137,239. A new lease was negotiated with the A.N.Z. bank for six years commencing on 19 September 1988. The rent that was reserved under this new lease was a minimum rent of \$420,000 per annum, but subject to review under the terms and conditions of the new lease.

The taxpayer claimed therefore to be entitled to deduct its half share of the amount paid to the lessee under section 51(1) of the Australian Act, the equivalent of section 104 of the New Zealand Income Tax Act 1976, being expenditure either:

- (a) incurred in gaining or producing its assessable income, or
- (b) necessarily incurred in carrying on a business for that purpose, and

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<sup>1</sup>92 A.T.C. 4918.

- (c) not being an outgoing of capital or a capital nature.

It was submitted by the taxpayer that the payment was for the purpose of bringing to an end an uneconomic lease "which [had] only one year to run" so they could enter into a more profitable lease. This submission ignored the option to renew the original lease for a further five years. It was stated that the co-owners had incurred expenditure of \$262,500 to earn \$420,000 in increased rent.

The Commissioner disallowed the deduction. The taxpayer appealed.

### (3) The Decision

*Hill J.* reviewed the 'traditional' cases concerning the characterisation of expenditure incurred.

(a) The starting point was the discussion of *Sir Owen Dixon* in *Sun Newspapers Ltd. v. F.C. of T.*<sup>2</sup> in particular where his Honour pointed out that the basic distinction between outgoings on capital account and those on revenue account lay in the distinction between:<sup>3</sup> "the business entity structure or organization set up or established for the earning of profit and the process by which such an organisation operates to obtain regular returns by means of regular outlay..."

Outlays in respect of the former being an outgoing on capital account, the latter on revenue account.

In that case *Dixon J.* stated three matters were to be considered. Briefly these were:

- (i) "the character of the advantage sought",
- (ii) "the manner in which it is to be used, relied upon or enjoyed", and
- (iii) "the means adopted to obtain it" that is, by way of a periodical payment or outlay or a final provision or payment.

Under (i) and (ii) his Honour said recurrence may play a part.

Reference was also made by *Hill J.* to the enduring benefit test of Viscount

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<sup>2</sup>(1938) 5 A.T.D. 87

<sup>3</sup>*Ibid.*, p. 93.

*Cave in British Insulated and Helsby Cables Ltd. v. Atherton.*<sup>4</sup>

*Hill J.* did not believe, on the evidence, that the taxpayer was carrying on a business. The lessors owned one property which they leased out for rental. He stated:<sup>5</sup> "The freehold held in co-ownership is, in such circumstances, the income producing entity, structure or organisation for the earning of the rental income of the co-owners. The freehold is the profit-making subject".

*Hill J.* referred to the first matter to be considered per *Dixon J.*, that is, the character of the advantage sought. The High Court in *G.P. International Pipecoaters Pty. Ltd. v. F.C. of T.*<sup>6</sup> described this to be the "chief, if not the critical, factor in determining the character of what is paid".

The advantage sought by the taxpayer was to bring to an end the lease with Mark Foys, Pty. Ltd. the lessee. By the payment, the taxpayer secured a permanent advantage, the surrender of the lease and its attendant option. "It could not be said that the advantage was ephemeral merely because immediately thereafter the applicant and its co-owner were able to enter into a new lease, all for a more advantageous rent".<sup>7</sup>

In respect of whether the taxpayer actually acquired any asset by virtue of the payment, his Honour said in terms of the law of Australia the acquisition by the payer of some asset is not essential for a payment to be of an income character. Of course if a capital asset is acquired by virtue of an outgoing, that fact generally will lead to the conclusion that the outlay is of a capital nature.

The second and third matters that *Dixon J.* referred to also supported the characterisation of the expenditure as being of a capital nature. Mr Justice *Hill* said:<sup>8</sup>

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<sup>4</sup>[1926] A.C. 205 at pp. 213- 214.

<sup>5</sup>92 A.T.C. 4918 at p. 4921.

<sup>6</sup>90 A.T.C. 4413 at p. 4420.

<sup>7</sup>92 A.T.C. 4918 at p. 4921.

<sup>8</sup>*Ibid.*, p. 4921.

The payment was a once and for all payment, it was not paid by way of a periodical reward or outlay to cover use and occupation for some period commensurate with the payment, nor could it appropriately be said to have been recurrent in the sense in which that expression is used in the cases.

A different view might be taken where the taxpayer's "business consisted of granting leases and obtaining surrenders of them as part of the normal ebb and flow of the business".

This last statement has a parallel with the New Zealand case of *C. of I.R. v. McKenzies N.Z. Ltd.*<sup>9</sup> which concerned a lump sum payment made by the lessee McKenzies to the lessor to rid itself of an onerous lease. In the course of his judgment in that case, *Richardson J.* said: "A lease will be held on revenue account if the taxpayer trades in leases so that the leases form part of its trading stock or are otherwise regarded as circulating capital".

(b) Reference was made by *Hill J.* to decisions in various other countries. In the United States, to the level of the United States Court of Appeals, payments by a landlord to a tenant to bring a lease to an end are not a business expense, instead they are - "an outlay of capital to be amortised over the term of the unexpired term of the old lease..."<sup>10</sup>

No direct authority existed in the United Kingdom. Some assistance was drawn from *Tucker (Inspector of Taxes) v. Granada Motorway Services Ltd.*<sup>11</sup> In this case, a landlord accepted a lump sum payment in consideration for tobacco duty no longer being included in the computation of the gross profits, which were a factor in the rental calculation. The payment so made was capital notwithstanding the fact that it was paid to enable the lessee to earn more profits.

His Honour received little assistance from *Lawson (Inspector of Taxes) v. Johnson Matthey plc*<sup>12</sup> a decision of the House of Lords. The facts, which he did not go into, were remote from the case before him. Counsel for the taxpayer had relied

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<sup>9</sup>(1988) 10 N.Z.T.C. 5233.

<sup>10</sup>92 A.T.C. 4918 at p. 4918.

<sup>11</sup>[1979] 2 All E.R. 801.

<sup>12</sup>[1992] 2 All E.R. 647.

upon the following statement of Lord *Keith of Kinkel*:<sup>13</sup> "A number of decided cases make it clear that a payment made to get rid of an obstacle to successful trading is a revenue and not a capital payment".

Lord *Keith of Kinkel* cited three cases in support of his proposition. After outlining briefly the facts of each, *Hill J.* concluded in none could there be said to be an advantage that accrued to a capital asset of the taxpayer as in the case before him. (In each of the three cases the taxpayer was carrying on a business).

His Honour also believed, even if it were correct to say the taxpayer before him carried on a business, the association between the payment and capital asset of the taxpayer (being the property available for lease) made the case before him closer to the facts of *Strick v. Regent Oil Co. Ltd.*<sup>14</sup> than to *B.P. Australia Ltd. v. Commissioner of Taxation of the Commonwealth of Australia*.<sup>15</sup> The distinction between those cases, according to his Honour lay largely in the fact that the method involved in providing for the trade tie in *Regent Oil* resulted in an interest in property being created, whereas that involved in *B.P. Australia*<sup>16</sup> did not.

#### (4) Conclusion

The case is similar to *McKenzies* case in New Zealand discussed in Part C. The fact situations are not dissimilar, both concerning payments to terminate leases. In terms of their analysis each referred to well established authorities as the basis for evaluating the facts. In *McKenzies*, *Richardson J.* began his discussion of the income-capital distinction by citing the observations of Lord *Pearce* in *B.P. Australia Ltd.* while in *Kennedy's* case *Hill J.*'s starting point was the discussion of Sir *Owen Dixon* in *Sun Newspapers Ltd.*

Accordingly in respect of the deductibility of payments made to terminate leases the New Zealand and Australian treatment is similar.

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<sup>13</sup>*Ibid.*, p. 649.

<sup>14</sup>[1966] A.C. 295.

<sup>15</sup>[1966] A.C. 224.

<sup>16</sup>*Ibid.*, p. 224.

## CHAPTER III

*F.C. of T. v. COOLING*

## 1. INTRODUCTION

The recent decision of the Full Court of the Federal Court in *Federal Commissioner of Taxation v. Cooling*,<sup>1</sup> in which the decision at first instance of Spender J.<sup>2</sup> was reversed and s. 25 of the Income Tax Assessment Act was held to be applicable to a payment made as an inducement to a firm of solicitors to enter into a lease, is one of the most significant decisions of recent years. When viewed with the decision in 1987 of the High Court in the *Myer Emporium Ltd.* case<sup>3</sup> it represents a substantial shift in the construction of s. 25 and a novel enlargement of the concept of income.<sup>4</sup>

This case is a landmark case in Australia for the court found what arguably a few years earlier would have been classified a capital receipt, to be an income receipt.

As a result of this decision the question has been raised, would the New Zealand Taxation Review Authority or courts follow this case if faced with similar facts. This is discussed in Part C of this thesis.

## 2. THE FACTS

The appellant, the Commissioner of Taxation appealed against the judgment of Spender J. The appeal was heard before Lockhart, Gummow, and Hill JJ. Hill J. gave the main judgment. His Honour had allowed the appeal of the respondent, Mr Cooling against an income tax assessment for the year ended 30 June 1986.

Mr Cooling was a partner in a firm of solicitors practising in Brisbane. Established in 1939, the firm had occupied premises in four different buildings in

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<sup>1</sup>90 A.T.C. 4472.

<sup>2</sup>89 A.T.C. 4731.

<sup>3</sup>87 A.T.C. 4363.

<sup>4</sup>Spry, *New Directions for Section 25: The Significance of Cooling's Case*, (1990) 19 Australian Tax Review, p. 158.



Brisbane prior to its move to Comalco House. The firm never owned the premises from which they practised, instead the firm always carried on its practice in leased premises. Over the years the firm had grown from two to six partners (one of whom left the practice on 31 December 1985).

The firm formed Bengil Services Pty. Ltd. ("Bengil") with the Commissioner's prior approval, to provide superannuation to its director employees (the partners) based on the salaries those employees earned for work performed for the firm of an administrative nature. One of the services that Bengil provided was the provision of rental office accommodation for the firm. Bengil had been the head lessor for some of the period of occupation by the firm of the premises at 127 Creek Street, the premises it occupied immediately before moving to Comalco House.

The premises at 127 Creek Street were not totally satisfactory to the firm. The configuration of space was regarded by the senior partner as "pretty unworkable." While additional space may have been available, that would have required the refitting of the total space. There was also no emergency power. In *Hill J.*'s words: "Hence the prospect of moving to new premises was not, in 1985, unattractive. The lease of the 127 Creek Street premises expired at the end of February 1986."<sup>5</sup>

The solicitors had acted for the owners of Comalco House, the A.M.P. Society. The real estate agents for the A.M.P. had raised the possibility of the firm moving to Comalco House in January 1984, prior to its completion. At that time negotiations took place but without success.

A year later the agents revived the possibility of attracting the firm as tenants in Comalco House, recommending to the A.M.P. Society the possibility of offering the firm concessions to make the move attractive. Suggested concessions were a cash payment or rent-free period of occupancy. These types of incentive packages (to attract tenants) were quite common in early 1985, as at that time there apparently was an oversupply of office space. Accordingly such incentives were a feature of the market for the rental of commercial premises.

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<sup>5</sup>90 A.T.C. 4472 at p. 4476.

The trial judge accepted that the attraction of a high calibre tenant to a number of floors in a building gave an opportunity for that tenant to be advertised with the hope of attracting further tenants to the building. When a certain percentage of the building was completed the extent of inducements significantly reduced perhaps even to the extent of being eliminated altogether.

The trial judge also found that the solicitors were reluctant to move from their existing premises. A proposal to lease the eighth floor commencing 1 July 1985 was put to the firm in April 1985. Under the proposal an incentive payment was to be made to the firm at the commencement of the lease of \$150,000. The proposal pointed out that the "rent free equivalent of the cash incentive offered, if applied on a rental basis, effectively reduces the rate of \$202 per square metre for the first two years to \$127.44 per square metre per annum." The proposal pointed out that, alternatively, the payment would fund the fitting out of the premises and leave the sum of \$50,000 to be utilised for other purposes.

There were a number of obstacles to be overcome before a lease could be finalised. Accordingly in August 1985 another package was put before the firm. The package provided that the commencement date of the proposed lease be 1 January 1986. Two alternative incentives were offered. The first incentive was to be the cash payment of \$150,000 with an area of 400 square metres being rent free for either 12 months or until the firm occupied or sublet the area, whichever was sooner. The alternative incentive provided for a cash payment of \$200,000. Additionally the A.M.P. Society would take over the residue of the lease contract of the firm at 127 Creek Street until 28 February 1986 when it was due to expire.

In October 1985 following discussions the firm indicated by letter that it, "or an entity to be nominated" by it wished to lease the eighth floor and inter alia taking part of it rent free for 12 months from the commencement of the lease or until occupied or sublet, commencing 1 February 1986.

The proposal ultimately accepted by the real estate agents on the A.M.P. Society's behalf resulted in a cash incentive payment of \$162,000 being agreed on. This was calculated applying the original \$150,000 figure pro rata on a square metre

basis. There remained to be resolved, so the solicitors said in a letter to the agents in November "the method of payment of the cash incentive".

The Society understood this to mean whether the payment would be by way of one lump sum to the partnership or as was ultimately chosen, a payment to the individual parties. Bengil's name first appeared in the correspondence as the prospective tenant in November 1985. The effect that this had on the whole transaction was only the standard requirement of the A.M.P. that the parties (the solicitors in this case) would guarantee the obligations of Bengil. The lease embodying the terms negotiated and the required guarantees was entered into on 12 December 1985. On 16 December cheques totalling \$162,000 were drawn in favour of the partners, pro rata to the interests of the respective partners in the firm's profits. Mr Cooling's share was \$21,060.

The payment was initially used by the partners to fund the move into, and fit out of, the new premises. The anticipated budget was for a total expenditure of \$205,009, to be spent on partitions (\$93,306), furniture (\$21,066), a new P.A.B.X. System (\$27,500), facsimile machines (\$4,200), with the balance (totalling \$6,500) for joinery, renovations, architect's fees, and what was called removalist expenditure. When the partitions, furnishings, etc had been paid for they were sold to a financier and leased back by the partners.

A letter dated 29 November 1985 from the agents addressed to and drafted by the senior partner of the firm preceded the payment. The letter referred to the sum: "as an incentive [paid to the partners] to sign the guarantees and to procure Bengil Services Pty. Ltd. to accept the lease. ... The above payment will be made on the execution of the lease and guarantees."

That description of the payment was repeated by the respondent by way of disclosure in his tax return.

Under cross examination Mr Cooling stated the payment was an inducement for the firm to shift premises and to take a lease.

Asked whether he regarded the payment as other than described in the 29 November letter, the senior partner of the firm Mr MacDonald replied that the sense

of the negotiations was that the partners of the law firm would take the lease. The fact of Bengil taking the lease arose only in the later part of proceedings to "sort of" comply with the guidelines of the Commissioner. The solicitors were however the ones both taking the lease and receiving the money.

### 3. *SPENDER J.*

His Honour held that the payment was made as an incentive for the firm to move premises. This was notwithstanding the terms in the letter of the 29 November 1985 drafted by Mr MacDonald or in the disclosure statement in Mr Cooling's taxation return. The situation was that the payment was made so that the solicitors would move premises. It was made independently of the entity formally taking over the lease. In one sense the payment was made for the giving of guarantees and to procure Bengil to take up the lease, as A.M.P. would not pay the incentive until the lease and guarantee documents had been executed. His Honour was of the opinion that the payment would have been made had the lease been taken up by the partners in the firm. In the course of his judgment, he said:<sup>6</sup>

In my opinion, the receipt in this case cannot properly be characterised as being fairly incidental to Mr Cooling's occupation as a solicitor. No doubt there is a connection, but the receipt of an incentive payment, a one-off receipt, cannot be described as fairly incidental to his practice as a solicitor. I do not regard *Myer* as requiring a receipt to be classified as income under sec. 25(1), if there is any connection between the receipt and the carrying on of a business.

The payment was accordingly received on capital account.

### 4. THE SUBMISSIONS - THE FULL FEDERAL COURT

For the purpose of this article, the Commissioner argued:

(1) *Spender J.* erred by not finding that the payment was made to induce Bengil to enter into the lease and for the firm undertaking the obligations of a guarantor in accordance with 29 November 1985 letter.

(2) A payment for undertaking the obligations of a guarantor was income

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<sup>6</sup>*Cooling v F.C. of T.* 89 A.T.C. 4731 at p. 4740.

in ordinary concepts, as was the fee for the service of procuring Bengil to enter into the lease.

(3) If *Spendor J.*'s findings above were correct, the payment was income in ordinary concepts in accordance with the High Court decision of *Myer*. The payment arose from a business operation or commercial transaction that was entered into in the ordinary course of the carrying on of the partnership business and with a profit element in mind.

(4) Alternatively, the payment made to Mr Cooling was as compensation or as a benefit in relation to services rendered and assessable income within section 26(e).

The Commissioner alternatively argued that the capital gains provisions applied.

The respondent, Mr Cooling, accepted if the payment was described as made for undertaking the obligations of a guarantor or as a fee for the service of procuring Bengil's execution of the lease, the payment was income. He however denied that this was the proper characterisation of the payment. The payment was not assessable under section 25(1) or 26(e) nor was it assessable income under the capital gains provisions.

## 5. THE DECISION OF THE FULL FEDERAL COURT

### (1) Income in Ordinary Concepts

*Hill J.* begins by summarising points arising from the cases on the distinction between income and capital.

(a) Whether an amount is characterised as income in ordinary concepts depends upon the quality in the hands of the recipient of the payment: see for example, *Scott v. F.C. of T.*<sup>7</sup>

(b) In respect of (a), as pointed out in *Hayes v. F.C. of T.*,<sup>8</sup> the donor's

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<sup>7</sup>(1966) 117 C.L.R. 514 at p. 526.

<sup>8</sup>(1956) 96 C.L.R. 47 at p. 56.

motive in making a payment will not necessarily be irrelevant, but it will not be determinative.

(c) The test to be applied is objective rather than subjective.<sup>9</sup>

(d) When a taxpayer is carrying on a business, the proceeds of that business are income in the taxpayer's hands and accordingly are assessable: *Squatting Investment Co. Ltd. v. F.C. of T.*<sup>10</sup>

(e) It is often necessary to make a "wide survey" and "an exact scrutiny of" the activities of a taxpayer: *Western Gold Mines N.L. v. C. of T. (W.A.)*<sup>11</sup>, to determine whether a particular profit has been derived from the business operation or is part of the taxpayer's business operations.

Comment:

If a taxpayer is carrying on a business, any proceeds from the carrying on of that business are assessable in effect being tainted or coloured by the activity of the taxpayer (per *Myer*). However not all transactions that occur in the course of a business are necessarily carried on as part of the taxpayer's business. It is therefore important to actually identify the precise nature and scope of the ordinary business of the taxpayer.

*Barwick C.J. in London Australia Investment Co. Ltd. v. F.C. of T.*<sup>12</sup> commented:

...what is produced by a business will in general be income. But whether it is or not must depend on the nature of the business, precisely defined, and the relationship of the source of the profit or gain to that business. Everything received by a taxpayer who conducts a business will not necessarily be income. As I have said, it must depend on the essential nature of his business and the relationship of the gain to that business and its conduct. (emphasis added)

As has already been seen in the cases decided after *Myer* discussed in this thesis, the courts have not always identified the ordinary business of the

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<sup>9</sup>Ibid., p. 55.

<sup>10</sup>(1952-1953) 86 C.L.R. 570 at p. 620 per *Fullagar J.*

<sup>11</sup>(1938) 59 C.L.R. 729 at p. 740.

<sup>12</sup>77 A.T.C. 4375.

taxpayer in a consistent manner. In some cases the taxpayer's activities have been defined broadly (for example *G.K.N. Kwikform*),<sup>13</sup> and others more narrowly (for example *Hytco*).<sup>14</sup>

(f) The distinction between capital and income is often difficult to draw. He quoted from what he called the "unduly pessimistic" view of Lord *Greene* M.R. in *I.R. Commrs. v. British Salmson Aero Engines Ltd.*:<sup>15</sup> "There have been many cases which fall on the borderline. Indeed, in many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons".

(g) Where profit arises from the disposal of property the issue of whether the profit is on revenue account is answered by applying the tests stated by the Lord Justice Clerk in *Californian Copper Syndicate Ltd. v. Harris*:<sup>16</sup>

...it is equally well established that enhanced values obtained from realization or conversion of securities may be so assessable, where what is done is not merely a realization or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business.

Proceeds from the realisation of assets will therefore be income where the nature of the business is such that of necessity the funds of the business are invested in assets which are from time to time realised (for example as is the case in a bank or insurance company). *Hill J.* stated:<sup>17</sup>

In such a case the acquisition and subsequent realisation will be a normal step in carrying on the relevant business, an act done in what is truly the carrying on of that business: *Colonial Mutual Life Assurance Society Ltd v FC of T* [(1946) 73 CLR 604] at p 620; *Chamber of Manufactures Insurance Ltd v FC of T*. 84 ATC 4315...

His Honour went on to state that "the fact that a transaction is a normal incident of the business activity will" mean that any profit derived from that business

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<sup>13</sup>*F.C. of T. v. G.K.N. Kwikform Services Pty. Ltd.* 91 A.T.C. 4336.

<sup>14</sup>*F.C. of T. v. Hytco Hiring Pty. Ltd.* 92 A.T.C. 4694.

<sup>15</sup>(1938) 2 K.B. 482 at p. 498.

<sup>16</sup>(1904) 5 T.C. 159 at pp. 165-166.

<sup>17</sup>90 A.T.C. 4472 at p. 4480.

will be characterised as income. The converse however is not the case. A profit arising from an unusual or extraordinary transaction may be income where the transaction was entered by the taxpayer with the intention or purpose of making the profit, as in the *Myer* case.

*Hill J.* moved on to indicators used to determine the character of profits or gains. His Honour said the recurrent nature of transactions suggests a profit derived from those transactions is income. However the fact that a transaction is 'one-off' will not preclude the profit generated as being an income receipt, as was made clear in *Myer*. Periodicity is a factor that leads to the conclusion that the periodical receipts are income: *F.C. of T. v. Dixon*.<sup>18</sup> However the fact that a payment is received in a lump sum or as a once and for all payment, does not necessarily mean the payment is received on capital account.

(2) Compensation for Services Rendered - The Form of the Transaction?

One of the arguments of the Commissioner was that the payment to the partners was for the services of undertaking the obligations of a guarantor. Such a payment would be income in ordinary concepts.

Similarly if the payment was characterised as being made for the service of procuring Bengil to accept the lease, it would again have the character of income.

It was submitted for the Commissioner that it was not open for *Spender J* to have found the payment was to induce the firm to move to Comalco House. Rather it was submitted his Honour was bound by the contractual stipulation as stated in the 29 November 1985 letter to find the payment was for the services stated therein. The Commissioner relied on *I.R. Commrs. v. Duke of Westminster*<sup>19</sup> as support for the proposition that the form of the transaction entered into by the parties was determinative of the character of the receipt in the respondent's hands.

*Hill J.* referred to Professor Parsons criticism of the use of this case to emphasise form rather than substance when it comes to the characterisation of a gain

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<sup>18</sup>(1952) 86 C.L.R. 540.

<sup>19</sup>(1936) A.C. 1.



as income.<sup>20</sup> In his work *Income Taxation in Australia*<sup>21</sup>, Parsons comments that there is no role for the *Duke of Westminster* doctrine "Where the context is the ordinary usage meaning of income and the only relevant statutory provision is the word 'income' itself in s. 25...". Parsons believes the doctrine's role should be "confined to the context of a specific statutory provision which attaches tax consequences to the adoption of a legal form".

*Hill J.* went on to analyse the *Duke of Westminster* doctrine. After citing Lord *Tomlin*, *Hill J.* states: "Nothing in what his Lordship said requires the conclusion that regard cannot be had to the whole context in which the agreement was made to determine the character of a receipt."<sup>22</sup>

In *W.T. Ramsay Ltd. v. I.R. Commrs.*,<sup>23</sup> Lord *Wilberforce* said of the principle in the *Duke of Westminster* case (at p. 323):

This is a cardinal principle but it must not be overstated or overextended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs...

*Hill J.* concludes, looking at the entire context in which the payment was made that *Spender J.* was entitled to find that the payment was an incentive to the firm so it would move, rather than a payment for services to be rendered by the firm. As that was the case, the characterisation of the payment as income was not determined by looking at the words of the letter of 29 November to the exclusion of all the circumstances that surrounded the payment and which provided the real context for the task of characterising the payment. The payment was made independently of the entity (Bengil) which formally took the lease over. Section 26(e) of the Australian Act concerning services therefore had no application.

"But so to find is but the start of the enquiry".<sup>24</sup>

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<sup>20</sup>90 A.T.C. 4472 at p. 4481.

<sup>21</sup>Parsons, *Income Taxation in Australia*, para 2.421.

<sup>22</sup>90 A.T.C. 4472 at p. 4481.

<sup>23</sup>(1982) A.C. 300 at p. 323.

<sup>24</sup>90 A.T.C. 4472 at p. 4482.

### (3) Capital or Revenue ?

According to *Hill J.*, *Spender J.*'s view that the payments were to be characterised as capital largely depended upon a finding that the receipt could not properly be characterised as being fairly incidental to the occupation of Mr Cooling as a solicitor. *Hill J.* cited the following passage from the judgment of *Spender J.*:

No doubt there is a connection, but the receipt of an incentive payment, a one-off receipt, cannot be described as fairly incidental to his practice as a solicitor. I do not regard *Myer* as requiring a receipt to be classified as income under s. 25(1), if there is any connection between the receipt and the carrying on of a business.<sup>25</sup>

It should be noted however that *Spender J.*'s finding that the payment was capital was based also on his interpretation of the decision of *Myer*.

During his judgment, *Spender J.* also said:<sup>26</sup>

In *Myer* the receipt was a lump sum for the assignment of future entitlement to interest. Had the interest been received under the loan agreement, the payments would clearly have been income, according to ordinary concepts, as receipts for the use of principal moneys. The lump sum received by *Myer* was in the nature of a surrogate for the future income flow.

It was not suggested in this case that the payment received by Mr Cooling was a payment to compensate for abnormally high rentals to be charged in respect of the premises to be leased. The evidence suggests that the rentals to be paid pursuant to the lease were at proper commercial rates.

In my opinion, *Myer* is not authority for the view that every receipt of business is 'income'. If it were, no sensible distinction between income and capital could be maintained.

The last statement is similar to the conclusion in *Spedley* concerning the application of *Myer*.

From the above passage it is clear that in *Spender J.*'s conclusion he did not classify the payment as a type of compensation receipt.

(a) Review of *Myer*. *Hill J.* summarised the two "strands of thought" in the *Myer* case. The second strand, that the lump sum was received in substitution for a stream of income, did not apply in *Cooling*.

The 'relevant' strand from the decision was that the gain made by *Myer* was

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<sup>25</sup>89 A.T.C. 4731 at p. 4740.

<sup>26</sup>*Ibid.*, pp. 4738-4739.

made in a business operation for the purpose of profit-making. Accordingly, even though the transaction was extraordinary when judged by reference to the ordinary course of the taxpayer's business, it was income in ordinary concepts. *Hill J.* cited the well-known passage from the judgment of the High Court:<sup>27</sup>

But a gain made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income. Whether it does depends very much on the circumstances of the case. Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or a "one-off" transaction preclude it from being properly characterized as income... (emphasis added)

R. F. Edmonds suggests contrary to what *Hill J.* went on to suggest, (discussed under the heading "The Present Case" following) the High Court was not "laying down a hard and fast rule which applied in every case, irrespective of the extraordinary nature of the transaction. It was, as the Court said, speaking generally."<sup>28</sup>

Edmonds refers as support for this the following passage from *Myer*:<sup>29</sup>

If the profit be made in the course of carrying on a business that in itself is a fact of telling significance. It does not detract from its significance that the particular transaction is unusual or extraordinary, judged by reference to the transactions in which the taxpayer usually engages, if it be entered into in the course of carrying on the taxpayer's business. And, if it appears that there is a specific profit-making scheme, it is pointless to say that it is unusual or extraordinary in the sense discussed. Of course it may be that a transaction is extraordinary, judged by reference to the course of carrying on the profit-making business, in which event the extraordinary character of the transaction may reveal that any gain resulting from it is capital, not income. (emphasis added)

Edmonds comments that the High Court contemplated that the extraordinary nature of a transaction as judged by reference to the course of carrying on the taxpayer's business, could be such that the gain that arose would be capital

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<sup>27</sup>87 A.T.C. 4363 at pp. 4366-4367.

<sup>28</sup>Edmonds *Cooling Questioned: A Correct Decision?* (1991) 25 Taxation in Australia No. 10, p. 736.

<sup>29</sup>87 A.T.C. 4363 at p. 4370.

not income. Edmonds submits even if the transaction entered into by Mr Cooling was entered into by him in the course of carrying on his business, the transaction in question when judged by reference to the transactions that he was normally involved in, was far more extraordinary than the transaction that Myer entered into, judged in terms of the same criteria. Not only was Myer the parent company of the group but immediately preceding the acquisition of Myer Finance Limited, some 17 days before the assignment of the income stream, Myer had undertaken for the group all its financing activities.

On this basis Edmonds suggests that the transaction entered into by Myer when judged by reference to the usual transactions in which it was engaged was not so extraordinary.

On the other hand, as was submitted by Mr Cooling, the business of the (legal) partnership was the performance of professional services not the receipt of incentive payments. Mr Cooling's submission and *Hill J.*'s response is discussed under the heading "The Present Case".

*Hill J.* noted the discussion of the *Californian Copper* case by the High Court in *Myer*. He also referred to their Honours' discussion concerning the reticence of courts to accept the "simple proposition" that a receipt was stamped with the character of income if there was an intention or purpose of making profit. *Hill J.* believed that *Myer* made it clear that a profit made in the course of carrying on a business will be a revenue profit where it is generated as "a profit component of a profit-making scheme."

While the statement seems straightforward, it still leaves the problem of actually deciding what the business of the taxpayer is. As seen with the cases already discussed this is not as easy as it may sound. It is however crucial to identify correctly the business of the taxpayer.

(b) The Present Case. *Hill J.* summarised the position to be:

If the transaction can properly be said to have been entered into by the firm in the course of carrying on its business and if it can be said that the arrangement is a profit-making scheme in the sense that those words are used by the High Court in *Myer* then it will follow that the amount received by the parties will be income and it will matter not that vis-a-vis the firm, the transaction was

extraordinary.<sup>30</sup> (emphasis added)

His Honour then looked at whether the transaction was entered into by the solicitors in the course of carrying on their business.

Mr Cooling submitted that the true nature and scope of the business of the partnership was the performance of professional services. It was not the receipt of incentive payments. This fact seemed to be accepted by *Spendor J.*<sup>31</sup> To this submission *Hill J.* stated:<sup>32</sup>

In my view this submission, while in one sense true, disguises the true nature and extent of the firm's business. It is true that the firm's business includes the rendering of professional services but the firm does not cease business when it moves from one set of leased premises to another as the decision of the High Court in *Lister Blackstone Pty. Ltd. v. F.C. of T.* 76 ATC 4285 at p. 4286...makes clear.

*Hill J.* however did not provide an alternative definition of what he regarded to be the "the true nature and extent of the firm's business". All we know is that the firm's business included the rendering of professional services.

In *Lister Blackstone* according to his Honour, the cost of moving from leased premises to other premises acquired when the first premises became inadequate, to the extent it was necessary to move stock and plant was an allowable deduction to an agricultural equipment distributor. *Hill J.* stated:<sup>33</sup> "The real issue in [*Lister Blackstone*] was not whether the expenditure in question was necessarily incurred in carrying on a business, but whether it was capital in nature. It was held that it was not on the facts of the case".

A number of points need to be made about these two passages:

(i) *Hill J.* states that the business of the firm "includes the rendering of professional services..." Surely that is the business of a firm of solicitors.

One may argue that the business of the firm was instead simply 'to make a profit'. If that view of the firm's business was adopted then potentially anything done

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<sup>30</sup>90 A.T.C. 4472 at pp. 4483-4484.

<sup>31</sup>89 A.T.C. 4731 at p. 4740.

<sup>32</sup>90 A.T.C. 4472 at p. 4484.

<sup>33</sup>*Ibid.*, p. 4484.

by the firm which produced a profit or gain would be assessable. If that line is taken however we are getting back to the submission of the Commissioner in *Spedley*, a submission that was firmly rejected by their Honours in *Spedley*.

(ii) While in *Lister Blackstone* expenditure incurred in moving leased premises was deductible, it was deductible to the extent that it was necessary to move stock and plant. The business of the taxpayer according to *Hill J.* was the distribution of imported agricultural equipment. The stock and plant were therefore clearly part of the business operations of the taxpayer. In *Cooling's* case the nexus between moving premises and the firm's day to day business operations was more tenuous.

(iii) Edmonds<sup>34</sup> comments contrary to his Honour's statement, the *Lister Blackstone* case concerned only the cost to move trading stock. The cost of moving plant had been broken out and was never an issue at trial (cf 75 A.T.C. 4165 at p. 4167).

(iv) On the basis of (iii) it is unclear therefore what authority, if any, the case is for *Hill J.*'s proposition below that where a taxpayer operates from leased premises, the moving from leased premises to other leased premises is an act of the taxpayer in carrying on his business.

(v) It is difficult to see the importance of *Hill J.*'s statement that the business of the firm does not cease when it moves leased premises. Arguably there may be a temporary cessation of business until the shifting is complete. Whether or not however the business does cease is surely of little relevance to the present enquiry.

#### (4) The Business Activity of the Taxpayer

*Hill J.* continued:<sup>35</sup>

Where a taxpayer operates from leased premises, the move from one premises to another and the leasing of the premises occupied are acts of the taxpayer in the course of its business activity just as much as the trading activities that give rise

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<sup>34</sup>Edmonds, *Cooling Questioned: A Correct Decision?* (1991) 25 Taxation in Australia No.10, p. 737.

<sup>35</sup>90 A.T.C. 4472 at p. 4484.

more directly to the taxpayer's assessable income. Once this is accepted, the evidence established that in Queensland in 1985 it was an ordinary incident of leasing premises in a new city building, at least where the premises occupied were of substantial size, to receive incentive payments of the kind in question. Why then should a profit received during the course of business where the making of such a profit was an ordinary incident of part of the business activity of the firm not be seen to be income in ordinary concepts?

It is extremely difficult to associate the moving of leased premises with the everyday activities of a solicitor such as the drafting of legal documents and conveyancing. The drafting of documents is an act carried out in the course of the taxpayer's business. Indeed it is a direct part of his business. The moving from and to leased premises on the other hand arguably is not unless the taxpayer regularly moves premises.

In respect of his Honour's comment above concerning such incentives being an "ordinary incident" in 1985 of leasing new premises, this does not mean that the profit made from the incentive payment was an "ordinary incident" of the solicitors' business activity. The provision of such incentives may have been an "ordinary incident" of the building industry but that fact should not colour the character of the payment in the recipient's hands. After all the nature of any payment must be judged by reference to its quality, or character in the hands of the recipient not the payer: *Scott v. F.C. of T.*<sup>36</sup>

His Honour suggests the profit in this situation "...was an ordinary incident of part of the business activity of the firm..." This compares to the *Myer* case where the transaction under scrutiny was "novel" yet was still part of Myer's profit-making business.

By stating that the move from and to leased premises was an act in the course of the taxpayer's business activity the court are taking a broad view of the facts and of what constitutes the business of the taxpayer.

The law firm had moved four times, prior to the move to the A.M.P. building in 1985. The firm was established in 1939. Consequently prior to the present move, in 46 years the firm had moved four times, one move approximately every 12 years. By contrast every day presumably it took instructions from clients, gave legal advice

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<sup>36</sup>(1966) 117 C.L.R. 514.

et cetera.

The business of the firm was the provision of professional services. If it did not occupy premises, it could not provide these professional services. However the leasing and moving of premises was no more an act of carrying on the business of the firm than the purchasing of the desks, chairs, filing cabinets and other items of furniture, items which are of a capital nature and accordingly depreciable. Without the provision of these items it would be extremely difficult if not impossible to provide the professional services. These items are capital, being in the words of *Dixon J.* in *Sun Newspapers Ltd. v. F.C. of T.*:<sup>37</sup> "...[part of] the business entity, structure, or organisation set up or established for the earning of profit..." The lease of premises is also part of the structure of a legal practice. On the other hand the actual performance of the legal services is "...the process by which such an organisation operates to obtain regular returns by means of regular outlay..."

*Myer* and *Cooling* reflect a shift from the fundamental distinction between the profit yielding structure and the process by which profit is earned to a distinction between transactions "in the course of the business activity" and various other transactions.

As mentioned above the Court is taking a broad view of the nature of the business activity in this case, an approach that *Spedley*<sup>38</sup> rejected. While moving premises and trading in goods may both be 'acts of a taxpayer in the course of its business activity', *Spedley*, which was cited with approval by his Honour, rejected the Commissioner's proposition based on *Myer* that an amount was income merely because that amount "was received in the course of business operations".<sup>39</sup>

In this respect R.G. Nenna comments:<sup>40</sup>

On the other hand, unlike the trading in goods for a merchant, the moving of

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<sup>37</sup>(1938) 61 C.L.R. 337 at p. 359.

<sup>38</sup>*F.C. of T. v. Spedley Securities Ltd.* 88 A.T.C. 4126 at p 4130.

<sup>39</sup>*Ibid.*, p. 4130.

<sup>40</sup>Nenna, *The Cooling Controversy: A Capital Case of Confusion*, (1991) 25 *Taxation in Australia*, No. 8, p. 626.



business premises:

\* would appear to have been 'extraordinary' when 'judged by reference to the transactions in which the taxpayer usually engages' - namely, the provision of professional legal services (per *Myer*) and

\* could not be said to have been 'part of the process by which the taxpayer operated to obtain its regular returns' - those regular returns also coming from the provision of the same professional services (per [*AVCO Financial Services Ltd. v. F.C. of T.* 82 A.T.C. 4246.]).

Furthermore, the observation of Hill J that it was common in Queensland in 1985 for incentives to be paid to induce businesses to relocate premises would hardly have been relevant if the relocation of premises was itself judged to be an extraordinary activity of the business.

Therefore, it is largely unclear as to what *Cooling's case* actually decided about the assessability of receipts derived in the course of a business.

Despite Mr Justice Hill's apparent rejection of the notion that all such receipts are necessarily assessable, it is difficult to rationalise his decision in the case, at least on this first ground, on any other basis.

#### (5) A Profit-Making Scheme

*Hill J.* stated another way to analyse the facts was to consider whether the transaction which gave rise to the incentive payment could be characterised as a profit-making scheme. "A scheme may be a profit-making scheme notwithstanding that neither the sole nor the dominant purpose of entering into it was the making of the profit."<sup>41</sup>

*Hill J.* supported this proposition with the decisions of *Myer* and *Moana Sand*.<sup>42</sup> In *Myer* an integral part of the reorganisation entered into by the Myer Group was the assignment of the right to interest. While the High Court referred to the case as involving the intention or purpose of making a profit, there was no suggestion that it dissented from the finding of *Murphy J.* that the motivating purpose of the transaction was to produce much needed working capital for Myer enabling it to diversify. *Hill J.* noted from the facts of the case that the obtaining of working capital was possible only if the profit contemplated by Myer was made.

The land sold in *Moana Sand* was acquired with a twofold purpose of working and/or selling surplus sand on it and subsequently holding the land until

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<sup>41</sup>90 A.T.C. 4472 at p. 4484.

<sup>42</sup>*Moana Sand Pty. Ltd. v. F.C. of T.* 88 A.T.C. 4897.

some future time when it became appropriate to sell the land at a profit. The profit again was held to be income in ordinary concepts even though the Court found that the resale of the land at a profit was not the dominant purpose of the company when it acquired the land.

In respect of the facts before him, *Hill J.* believed the transaction which produced the incentive payment could be categorised as a profit-making scheme on the following basis:

- (a) The transaction entered into by the solicitors was a commercial transaction.
- (b) The transaction formed part of their business activity.
- (c) "...a not insignificant purpose" of the transaction was to obtain a commercial profit by way of the incentive payment.

Nenna comments: "But is that definition consistent with the notion of profit-making scheme 'in the sense that those words are used by the High Court in *Myer*?'"<sup>43</sup>

In *Myer* the High Court held concerning the loan agreement and the subsequent assignment of the right to income from the loan:

...from the viewpoint of Myer the two transactions were essential and integral elements in an overall scheme, that scheme being a profit-making scheme.

If the two transactions, namely the loan agreement and the assignment, are considered as separate and independent transactions, Myer's argument that no relevant profit arose from the assignment has compelling force...<sup>44</sup> (emphasis added)

Profit-making schemes have been characterised in past cases as comprising more complex arrangements than in the present case of *Cooling*. These complex arrangements have been described as involving "a plan, design or programme of action" (*X.C.O. Pty. Ltd. v. F.C. of T.*),<sup>45</sup> or as "activities which are co-ordinated by

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<sup>43</sup>Nenna, *The Cooling Controversy : A Capital Case of Confusion*, (1991) 25 Taxation in Australia, No. 8, p. 626.

<sup>44</sup>87 A.T.C. 4363 at p. 4370.

<sup>45</sup>(1971) 124 C.L.R. 343.

plan or purpose" (*Investment & Merchant Finance Corp. v. F.C. of T.*).<sup>46</sup>

R.G. Nenna<sup>47</sup> points out that applying the three-point test stated by Hill J. above to the second of the two transactions in the *Myer* case, being the assignment of the income stream for consideration, that transaction would itself have constituted a profit-making scheme, in the sense it was: "...a commercial transaction; it formed part of the business activity of the firm [albeit extraordinary] and a not insignificant purpose of it was the obtaining of a commercial profit by way of the incentive payment" per *Cooling*.<sup>48</sup>

This is contrary to the statement from *Myer* above where it was said when "the two transactions are seen as integral elements in one profit-making scheme, it is apparent that Myer made a relevant profit".

The facts in *Cooling* are far more simple than *Myer*. There were not the complex steps involved. The facts were that the firm after preliminary discussions, committed itself to lease a new building, in return for a lease incentive.

#### (6) Profit-Making Purpose?

To constitute a "profit-making scheme" cases state there must be a profit-making purpose. In the *Westfield* case<sup>49</sup> Hill J. states:

...where a transaction occurs outside the scope of ordinary business activities, it will be necessary to find, not merely that the transaction is "commercial" but also that there was, at the time it was entered into, the intention or purpose of making a relevant profit.

The property must have been acquired for "the purpose of profit-making by sale."

In *Cooling's* case sound commercial reasons were given for the move. The configuration of space was "pretty unworkable". Any additional space which may have been available would have required the whole area to be refitted. There was also no emergency power. As Hill J. stated: "Hence the prospect of moving to new

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<sup>46</sup>71 A.T.C. 4152 at p. 4155.

<sup>47</sup>Nenna, *The Cooling Controversy: A Capital Case of Confusion*, (1991) 25 Taxation in Australia, No. 8, p. 626.

<sup>48</sup>90 A.T.C. 4472 at p. 4484.

<sup>49</sup>*Westfield v. F.C. of T.* 91 A.T.C. 4234 at p. 4241.

premises was not, in 1985, unattractive." The lease the solicitors had on the property they occupied before shifting, expired at the end of February 1986. It was therefore logical in 1985, for the firm to consider as an option, along with renewing the existing lease, the possibility of shifting to more suitable premises. As it happened the commencement date for the lease was 1 February 1986.

The decision to move was therefore a sound commercial decision based on the needs of the firm in carrying on its business. A stronger case for the assessability of the incentive payment (as being received as part of a profit-making scheme) could perhaps be argued if the firm had been only part way through its existing lease when it decided to move.

Whether the receiving of a lease incentive payment could ever on its own amount to a profit-making purpose is doubtful. Like any business decision, the decision to move to new premises takes into account both the one-off costs such as the moving to and the fitting out of the new premises and the ongoing costs such as rent and heating. The decision to move is made for economic reasons.

Nenna<sup>50</sup> gives an example, based on *Cooling's* case, where a business person by committing to new leased premises:

- (a) would be entitled to receive an incentive payment of \$100,000; but
- (b) anticipates incurring \$150,000 in relocation and set-up costs in doing so. (In *Cooling's* case the anticipated budget was for total expenditure of \$205,009 for the relocation and fit-out while cheques totalling \$162,000 were drawn in favour of the partners).

He further comments whether an amount is income in ordinary concepts is determined based on the test of the quality of the payment in the hands of the recipient: *Scott v. F.C. of T.*<sup>51</sup> Accordingly would it be more commercially rational for the business person to regard the commitment to the new lease as:

- (a) a scheme whose purpose was to yield a prospective profit of \$100,000?;

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<sup>50</sup>Nenna *The Cooling Controversy: A Capital Case of Confusion*, (1991) 25 Taxation in Australia No. 8, p. 627.

<sup>51</sup>(1966) 117 C.L.R. 514 at p. 526.

or

(b) a scheme the purpose of which was to obtain "new business premises for a lower net capital cost than may otherwise have been the case (\$50,000 instead of \$150,000)?"

As the evidence showed in *Cooling's* case, taxpayers generally will enter into commercial leases for the reason that they need premises from which to carry on their business. Generally costs of setting up in the new premises would be budgeted for. Accordingly, Nenna argues, if and when an incentive payment can be negotiated, at best the payment is likely to be regarded as a windfall receipt mitigating the cost of doing the transaction. On this basis the receipt would not be a "purpose" for performing the transaction. "In fact, taking such a proposition to its logical conclusion highlights its inherent absurdity."<sup>52</sup>

Nenna illustrates this by the example of a business operating from premises which during the term of its lease accepts an offer to commit to a new lease. An incentive payment of \$100,000 is made while costs to shift and fit-out the premises amounted to \$150,000. If the offer had been accepted for the purpose of making a profit of \$100,000, at the end of the day in terms of net cash position, the recipient of the incentive actually faces a loss of \$50,000. The 'profit-making scheme' has cost the business \$50,000. Rather than being a 'profit-making scheme' it has become a 'loss making scheme'.

He points out that the decision to move into the new premises may still be commercially sensible if it is anticipated that the business will operate more profitably from the new premises, for such reasons as being in a more favourable location. The commercial analysis in making the decision to move in Nenna's example would be whether the projected incremental profits from the new premises would provide a sufficient rate of return for a \$50,000 net capital outlay/investment. Again on this analysis any \$100,000 profit from the transaction is illusory.

In *Cooling* the firm had budgeted on spending \$205,009 on moving premises

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<sup>52</sup>Nenna, *The Cooling Controversy: A Capital Case of Confusion*, (1991) 25 Taxation in Australia No 8, p. 627.

and the fit-out of the new premises. Cheques of \$162,000 were drawn in favour of the partners. The \$162,000 profit was therefore illusory when an overall view is taken of the transactions involved. There were however genuine commercial reasons for the shift even though overall the shift involved a net cost to the firm.

(7) Compensation For Future Capital Loss?

It may even be argued that the payment while an incentive for the firm to move premises, was made by the A.M.P. to reimburse the partners who were to expend \$205,009 on the move on such items as partitions and furniture, all items of capital. The payment was therefore a payment to compensate for a (future) capital loss or outgoing of the taxpayer.

As a general rule compensation received for the loss, or the loss of use, of a capital asset will be regarded as of a capital nature and accordingly not assessable. See for example *Glenboig Union Fireclay Co. Ltd. v. I.R. Commrs.*<sup>53</sup> and *McLaurin v. F.C. of T.*<sup>54</sup>

The decisions of *McLaurin* and *Allsop v. F.C. of T.*<sup>55</sup> state that where a compensation payment is in respect of items some of which are of a revenue nature and others are not, and the amount relating to the revenue items cannot be apportioned or dissected from the receipt, no part of the receipt is income. Parsons<sup>56</sup> comments that it would seem that dissection "is only appropriate where the taxpayer can be said to have assented to several amounts in respect of specific items of an income character".

The payment to the solicitors in *Cooling's* case accordingly would have retained its capital nature if it represented compensation for both capital and revenue losses or outgoings and no dissection or apportionment between the two was possible.

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<sup>53</sup>(1922) 12 T.C. 427.

<sup>54</sup>(1961) 104 C.L.R. 381.

<sup>55</sup>(1965) 113 C.L.R. 341 .

<sup>56</sup>Parsons, *Income Taxation in Australia*, para. 2.562.

In addition whether the undissected lump sum payment is to compensate the taxpayer wholly or in part for a capital loss or outgoing, its nature as a capital item is unaffected by the basis used to calculate the payment, for example as subsidised or reduced rent. In *Glenboig* the method of calculating the compensation was not conclusive as to the nature of the expenditure.

It is however settled that a payment made to a taxpayer that is calculated to compensate for capital losses or outgoings can represent income in the hands of the recipient, where for example the compensation was paid in consideration for services provided by the taxpayer: *G.P. International Pipecoaters Pty. Ltd. v. F.C. of T.*<sup>57</sup>

This was clearly not the case in *Cooling*. Hill J. agreed with the finding of Spender J. stating:<sup>58</sup> "...his Honour was, in my view, entitled to find as he did that the payment was as incentive to the firm to cause it to move rather than a payment for services to be rendered by the firm". (emphasis added)

Both Spender J. and Hill J. however saw the payment as being an incentive to move rather than to compensate for capital losses.

#### (8) Part of the Profit-Yielding Structure?

R.G. Nenna<sup>59</sup> suggests that in cases such as *Cooling's* the lease incentives are paid to the taxpayers in consideration for the taxpayer's undertaking to enter a contract to lease premises. Nenna states that in Australia it is tax law that:

When a recipient of money provides consideration for the payment, the consideration will ordinarily supply the touchstone for ascertaining whether the receipt is on revenue account or not...The character of the receipt may then be determined by the character, in the recipient's hands, of the matter in respect of which the moneys are received."<sup>60</sup>

In the *Federal Coke* case the holding company of the taxpayer released a customer from a contract to purchase coke from the holding company in exchange for

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<sup>57</sup>90 A.T.C. 4413.

<sup>58</sup>90 A.T.C. 4472 at p 4482.

<sup>59</sup>Nenna, *The Cooling Controversy: A Capital Case of Confusion*, (1991) 25 Taxation in Australia, No. 8, p. 628.

<sup>60</sup>*Federal Coke Co Pty Ltd v FC of T* 77 ATC 4255 at p 4273, per Brennan J.

a payment made to the taxpayer.

The consideration given by the taxpayers in *Cooling*, as recipients of the lease inducement, was the commitment to a binding contract to lease premises. Such a lease generally will comprise part of the capital structure of a taxpayer's business (see for example, *C. of I.R. v. McKenzies N.Z. Ltd.*)<sup>61</sup>

On this point Nenna draws an analogy with the High Court decision of *Dickenson v. F.C. of T.*<sup>62</sup> The Court held that the two payments of 2000 pounds made to 'induce' the taxpayer to enter into the restrictive covenant were capital receipts of the business. The payments were capital receipts because the agreement entered by the taxpayer affected the capital structure of the taxpayer's business. *Kitto J.* stated:<sup>63</sup> "[The amounts] were really payable in connection with the whole machinery by which the desired tie to the Shell Company was accomplished, and not with any one part of that machinery considered by itself".

The taxpayer in *Cooling's* case was induced by a payment to enter into a lease of the premises for a fixed term from which he would carry on business. A lease is generally a capital asset (see *McKenzies* case). In this case it clearly formed part of the profit-yielding structure of the taxpayer's business. He would carry on his income earning business from those premises. The lease agreement accordingly affected the taxpayer's capital structure and the lease payment based on *Dickenson* should be a capital receipt.

#### (9) The Alternative Possibility Test

In support of his finding (at (5)) that the transaction which produced the incentive was a profit-making scheme. *Hill J.* stated the firm had the alternative of:

- (a) paying a lower rent and obtaining a smaller tax deduction for its outgoings; or
- (b) paying a higher rent (assuming, he said, that Bengil passed on the rent

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<sup>61</sup>(1988) 10 N.Z.T.C. 5233).

<sup>62</sup>(1958) 11 A.T.D. 415.

<sup>63</sup>*Ibid.*, p. 493.



holiday) for which it could claim a larger tax deduction and receiving an amount in the form of assessable income.

Following further discussion, he concluded that the payment was income in ordinary concepts.

It is unclear whether *Hill J.* was proposing that in determining the character of a payment received by a taxpayer, other proposed or hypothetical alternative forms by which the payment could have been made should be examined. Presently in examining the character of a payment factors such as the recurrence of the payment and the quality of that payment in the hands of the recipient determine the characterisation of a receipt. Only in a few cases, perhaps for example, where an annuity has been commuted and paid in a lump sum, do the courts look at alternative forms the payment could have taken.

To suggest that the possible alternative forms of payment should be examined by the court negates to some extent tax planning. A goal of tax planning is to structure transactions to minimise the incidence of tax. Where there are numbers of forms a transaction can take to achieve the same result but with varying tax consequences, the taxation consequences will along with other considerations determine the form the transaction takes.

If in one form a payment will constitute a capital receipt to the recipient while in another form it will constitute an income receipt and therefore be assessable, generally the form producing a capital receipt will be chosen. If the capital nature of that receipt were to be challenged, following *Hill J.*'s lead, a court could look at other forms the payment could have taken. Such examination could turn the capital receipt into an assessable revenue receipt. The other tests such as recurrence and the quality of the receipt in the hands of the recipient, may indicate the particular receipt to be of a capital nature. However because in another form the payment would have constituted a revenue receipt, on *Hill J.*'s statement potentially the actual payment could take on the character of the alternative form by which the payment could have been made.

In *Cooling*, *Hill J.* used this 'test' of looking at alternative forms of payment

to support his findings of assessability. It is unclear therefore whether this 'test' could be used as the primary 'test' in determining the character of a payment. Nor is it clear whether in fact this 'test' would displace other tests such as recurrence in determining the character of a payment.

R.G. Nenna raises the point if the alternative form can determine the character of the payment, irrespective of the actual form and reason for the payment.<sup>64</sup>

...why would it not be possible for a prospective lessee, when the demand for leased premises outstrips supply and it is given a choice as to whether to pay a premium for entering into a lease or to pay a higher rent, that it will accord with common sense to argue that the premium would be deductible because the lessee would otherwise have been entitled to a tax deduction for that higher rent?

He further states that *Dickenson v. F.C. of T.* was a case that could be perceived to be analogous to *Cooling's* case. This alternative consideration 'test' could have been applied by the High Court in *Dickenson* but was not. As already mentioned *Dickenson* was concerned with a tie entered into by the taxpayer under which he agreed to sell only a particular oil company's product in return for payments. The High Court held the payments to be of a capital nature. It would have been open to the parties to have structured the payment by way of a lower deductible purchase price for the fuel supplied under the trade tie agreement. Instead *Dixon* C.J. remarked that receiving an amount for a tie in the circumstances was not a normal incident of carrying on the business of a garage proprietor.

Nenna further comments that this 'test' "does not accord with the conventional tax law determining the income - capital distinction for business receipts."

#### (10) Conclusion

##### (a) The Court held:

(i) The trial judge was entitled to find that the payment was an incentive to the firm to move rather than a payment for services rendered by the firm as

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<sup>64</sup>Nenna, *The Cooling Controversy: A Capital Case of Confusion*, (1991) 25 Taxation in Australia, No. 8, p. 627.

contended by the Commissioner. The nature of the payment as income was not to be determined by focusing on the words of the 29 November letter to the exclusion of all the circumstances that surrounded the payment and which provided the real context in which the task of characterisation was to be made. Section 26(e) relating to services had no application.

(ii) Where a taxpayer operates from leased premises, the move from and to premises and the leasing of premises occupied are acts of the taxpayer in the course of its business activity, just as much as its trading activities that more directly give rise to the taxpayer's assessable income. The transaction entered by the solicitors was a commercial one; it formed part of the firm's business and a not insignificant purpose of the transaction was to obtain a commercial profit by way of the incentive payment. The payment was therefore income according to ordinary concepts and was assessable under section 25(1).

The Court also discussed the application of the capital gains tax provisions.

(b) The application of *Cooling*. At the end of the day the decision in *Cooling* leaves many unanswered questions. Are the principles enunciated in the decision to be applied widely and to all cases where there is a cash lease incentive. Alternatively, will the application of the case be limited to the circumstances similar to those that arose in that case. Where do non-cash incentives fit in? Does *Cooling's* case apply also to those incentives? In Australia at least, the courts tend to construe legislation and authorities in a way that is beneficial to the Commissioner.

R.G. Nenna<sup>65</sup> poses a number of fact situations, different from those in *Cooling* and asks whether the principles in *Cooling* apply? Specifically:

(i) If the *Cooling* decision is ultimately justified on the view that the incentive payment was to be compensation for future rental expenses, would the principles in *Cooling's* apply if the facts were that the payment was made as consideration for committing to a lease, and the payment was calculated to compensate for specific capital costs of doing so?

(ii) If the decision in *Cooling* is justified on the fact that the relocation of

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<sup>65</sup>Ibid., p 629.

premises was undertaken as part of an ongoing business, and not on the cessation of a business, what is the position where payments are made to a taxpayer in consideration for:

(a) entering into its first leased premises on commencing its business, (for example, the taxpayer is establishing its capital structure)?; or

(b) on an expansion of its existing business, the taxpayer enters into additional leased premises, (for example, the taxpayer is adding to its capital structure)?

"In other words, what about lease incentives paid otherwise than 'where a taxpayer operates from leased premises' " and, contrary to the facts in *Cooling* on which *Hill J.* seems to have expressly based his judgment, the leasing of premises is not just part of "the move from one premises to another."<sup>66</sup>

In response to proposition (a) above, the income tax ruling *IT 2631 "Income Tax: Lease Incentives"* states:<sup>67</sup>

The question arises as to whether an incentive paid to a taxpayer entering into a lease to commence an entirely new business is income. On balance, it is considered that the decisions in *Myer* and *Cooling* could not be interpreted to treat a one-off payment of this kind to a new business taxpayer as income.

This statement is made under the heading "Non-cash Payments". Whether it also applies to cash payments is unclear. The ruling states the position in respect of cash payments to be:<sup>68</sup> "In view of the decisions in *Myer* and *Cooling*, where a business taxpayer is given a cash incentive to enter into a lease of business premises, the incentive is income of the taxpayer".

Presumably the principal stated in the ruling under the heading "Non-Cash Payments" in respect of a new business taxpayer would also apply to cash incentives.

The ruling is discussed in the third part of this thesis.

(iii) If the decision is based merely on the fact that the payment was received "in the course of its business", how can this be reconciled with *Hill J.*'s

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<sup>66</sup>*Ibid.*, p 629.

<sup>67</sup>*IT 2631 Income Tax: Lease Incentives* Supplement to (1991) 25 Taxation in Australia, No 11, at R.46.

<sup>68</sup>*Ibid.*, R.45.

apparent acceptance of the view in *Spedley* that not all receipts that are derived in the course of business operations are necessarily income?

(iv) Nenna suggests it may be possible for a taxpayer to re-argue the proposition, that to commit to a commercial property lease is not necessarily a profit-making scheme if it is done with the sole intention of securing business premises, and, moreover if the capital costs (of relocating etc) are budgeted to exceed the incentive payment being offered. (Arguably this was the intention of the taxpayer in *Cooling*, the incentive was in effect a bonus for so moving). On this point, I believe the arguments would have to be strong for any court not to follow *Cooling's* case.

(c) Potential Injustices of the Decision. Romano Nenna in a later article<sup>69</sup> gives four illustrations of injustices to tenants that could arise from the application by the Commissioner of the *Cooling* decision.

(i) A business tenant who has a long lease is induced to move into new leased offices by an incentive payment. However to be able to move and receive the incentive, the tenant has to pay the present landlord compensation in order to surrender the lease. The compensation payment is a capital expenditure. (See *C. of I.R. v. McKenzies N.Z. Ltd. and Kennedy Holdings Ltd. and Property Management Pty. Ltd. v. F.C. of T.*)<sup>70</sup> It cannot be offset against the incentive payment which from *Cooling's* case is a taxable gain. This is despite the two payments being commercially inextricably connected.

The Inland Revenue may even argue in this situation that the case for the assessability of the lease incentive is stronger as it appears the sole reason for moving into the new premises was to receive the lease incentive.

(ii) A business tenant spends in excess of the lease incentive received on fitting out a new office. The incentive is assessable as income while the costs of fitting out the new office will be capital expenditure ( a deduction for depreciation may however be available).

It is likely in most situations that the costs of shifting and fit-out will exceed

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<sup>69</sup>*Income and Capital: The Cooling-off Period*, (1992) 26 Taxation in Australia No.7, p. 359.

<sup>70</sup>92 A.T.C. 4918.

any incentive provided as was the case in *Cooling*.

(iii) A tenant is directly compensated by a landlord for the costs of moving and fitting-out new premises. While the compensation payment is taxable as income, no tax deduction is allowed for the costs. Again as with (ii) a depreciation deduction may be available for fit-out items.

(iv) Rather than being in receipt of an inducement, the tenant pays a premium to a landlord to gain space in a new building. This can be the case when the property market is buoyant. A tenant will not receive a deduction for the premium, being capital. However receipts in an equivalent context are assessable as income.

(d) *Myer and Cooling*. At the beginning of the chapter I quoted I.C.F. Spry<sup>71</sup> who commented, inter alia: "When viewed with the decision in 1987 of the High Court in the *Myer Emporium Ltd* case it [*Cooling*] represents a substantial shift in the construction of s. 25 and a novel enlargement of the concept of income".

The decision of *Cooling* is significant in this sense. A one-off lump sum payment which was not calculated with reference to rent or any income measure, and arguably not received in the carrying on of the taxpayer's (ordinary) business was held to be income. The decision following on from *Myer* has potentially broadened the scope of transactions which will be part of the business of the taxpayer and assessable. Arguably if the facts in *Cooling* had come before a court a few years earlier, the court may well have decided on the cases available that the receipt was properly capital.

In addition *Hill J.* supports his decision by way of what has been labelled 'the alternative possibility test'.

In the *Myer* case the lump sum payment which represented a capitalisation of rights to receive a number of annual interest payments was held to be income. Along with the reasons given, in the thinking of their Honours in *Myer* undoubtedly were the millions of dollars in tax at stake. This may also have been in the minds of their Honours in *Cooling*. It is significant in the *Myer* case that the arrangement

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<sup>71</sup>Spry, *New Directions for Section 25: The Significance of Cooling's Case*, (1990) 19 Australian Tax Review, p. 158.

subject to the Court's scrutiny was part of a scheme which involved inter alia, tax minimisation. The High Court commented, "The loan would not have been given to Myer Finance if Citicorp had not been in a position to take the assignment of the right to interest."<sup>72</sup>

As J. Mews comments:<sup>73</sup>

The apparent glaring weakness in the taxpayer's argument in *Myer* was the very extent of their complete preplanning of all the incumbent transactions. It is quite clear from the facts that the plan to make the loan and assign the right to receive the interest were in place prior to the acquisition of the subsidiary company to which the loan was to be made. These pre-arranged steps were provided in formal advice from a range of professional advisers and such was acknowledged freely by the taxpayer.

In the case of *Cooling* however, Spry comments there was no purpose of tax minimisation except insofar as the parties entering the lease did so expecting that the incentive payment would be a capital not income receipt. This however is not tax minimisation. Such an expectation was not unreasonable given past cases on the distinction between income and capital.

The transactions in *Myer* would not have been undertaken in the form they were had the taxpayer known the profit would have been assessable. In *Cooling* however, on the basis of the reasons given in the case for the move, the move would have occurred at some time irrespective of the provision of an incentive. (The incentive may have influenced the particular premises ultimately leased and timing of the move, although this is not stated). I.C.F. Spry<sup>74</sup> states:

Nonetheless it may be fairly pointed out that although *Cooling's* case...did not involve an artificial tax minimisation scheme, if the payment in question had not been held to be assessable an observer might have regarded the case as one where it had slipped through the income tax net and that in that sense an unfair benefit had been obtained. Perhaps in that sense the decision of the Full Court may be regarded as resting ultimately on subjective considerations of fairness rather than on objective considerations of law.

Tax law is not however not always based on fairness but on principles which

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<sup>72</sup>87 A.T.C. 4363 at p. 4365.

<sup>73</sup>Mews, *Recent Trends in Sections 25 and 51-A Commercial Approach?*, (1987) 22 *Taxation in Australia*, No.4, p. 221.

<sup>74</sup>Spry, *New Directions of Section 25: The Significance of Cooling's Case*, (1990) 19 *Australian Tax Review*, p. 158.

have been developed often over many years.

(e) Transactions in the Ordinary Course of a Business Activity. As noted earlier in *Myer* and *Cooling* (and other decisions) there has been a shift from the traditional fundamental distinction between the profit-making structure and transactions in the course of the operation of the structure (the "income earning process") to a distinction between transactions which are made "in the course of a business activity" and other transactions.

It is therefore important to identify correctly the taxpayer's business and intention and also to distinguish between transactions which are made "in the course of a business activity" and other transactions. It is submitted in *Cooling*'s case that the Full Federal Court did not correctly identify the business of Mr Cooling.

(f) The Need for Certainty. The decision in *Cooling* has done little to clear the confusion over the interpretation of the High Court decision in the *Myer* case.

In refusing special leave to hear the taxpayer's appeal, the High Court has implicitly confirmed that the Full Federal Court's decision in *Cooling* was correct. As noted earlier there are a number of possible rationale for the decision in *Cooling*. The Court by not allowing special leave has passed by a chance to indicate the rationale that supports the decision. It is therefore unclear whether *Cooling* applies only to the particular facts of the case or has a wider application. The Australian Commissioner has naturally taken the latter view. However following *Myer*, *Cooling* and other recent court decisions:

Taxpayers looking to decisions of the courts for some guidance in planning their tax affairs, complying with the tax law or at least in trying to make vital distinctions between income and capital gains may conclude that the exercise is a waste of time.

Long-established High Court principles can no longer be relied on as guidelines for assessing capital/income distinctions in any given circumstances. Now it's necessary to consider each matter on a case-by-case basis.<sup>75</sup>

Nenna illustrates the uncertainty that has arisen from the various court decisions by comparing *Cooling* with *F.C. of T. v. Westfield*.<sup>76</sup> In *Cooling*, the Court

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<sup>75</sup>*Income and Capital: The Cooling-off Period* (1992) 26 *Taxation in Australia*, No. 7, p. 358.

<sup>76</sup>91 A.T.C. 4234.



ruled that the cost incurred by a solicitor moving premises was part of the solicitor's ordinary business. However, in *Westfield*, the Court ruled that the sale of land by a developer of land was not in the course of its business.

In, as Nenna refers to it, the "brave new world" of self-assessment, taxpayers need greater certainty than there is at present:<sup>77</sup>

...they cannot afford to concede that, as Lord Greene MR put it in *Inland Revenue Commissioner v British Salmson Aero Engines Ltd*:<sup>78</sup>

'...the spin of the coin would decide the matter [of the distinction between capital and revenue] almost as satisfactorily as an attempt to find reasons.'

There is therefore a need for greater certainty in order that taxpayers can plan transactions and anticipate the taxation implications of those transactions. Taxpayers require decisions showing a consistent approach based on sound reasoning. This is all the more necessary in the system of self-assessment in Australia. To this end, Nenna notes the observations of Dr Y.F.R. Grbich, a member of the Administrative Appeals Tribunal, in *Case X85*,<sup>79</sup> a case turning on the distinction between income and capital.

Dr Grbich refers to the role of the A.A.T., a role Nenna suggests also has application to the Australian Courts (quoting from Nenna's article):

I do not think that an important issue such as this should be settled by an empty exercise in word games, in juggling round labels like 'gambling' or 'speculation' or 'business' in a vacuum as if this helped to clarify the hard decisions.

In giving coherence to the important concept of income in the brave new world after *Myer* and Pt IIIA, we must go back to the underlying reasons for the rule.

In times of great change it is more important than ever to assert basic principles, and to look at the underlying reason for the rules administered by this Tribunal. It is important to locate the Tribunal in a modern, mass decision-making, self-assessing tax system.

When the legislature lays down broad rules these predicate discretions, not only for bureaucrats, judges and tribunal members, but also for self-assessing

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<sup>77</sup>Nenna, *The Cooling Controversy: A Capital Case of Confusion*, (1991) 25 *Taxation in Australia*, No. 8, p. 629.

<sup>78</sup>(1938) 2 K.B. 482 at p. 498.

<sup>79</sup>90 A.T.C. 615.

taxpayers who must use those rules as a basis of numerous day-to-day decisions.

In this context it is important that the Tribunal both encourage bureaucrats and itself contribute to the coherent structuring of that discretion so that the law develops in a systematic and orderly fashion.

It is important that such structuring be guided by the broader economic framework in which the tax system must operate. (Paragraph breaks as inserted in R.G. Nenna's article)<sup>80</sup>

Presently in Australia, the relevance especially for business taxpayers of the income/capital distinction is unclear following the *Myer* case.

(g) The Interpretation of the Federal Court. One final point noted by I.C.F. Spry,<sup>81</sup> which links in with the comments above is:

...the Federal Court especially continues to show itself to be inclined to construe legislation and construe authorities in a way that is beneficial to the Commissioner. This has given rise to a position in which it is very difficult for taxpayers to proceed on the basis that a traditionally strict construction will be accorded to relevant provisions. There is seen to be a substantial risk that accepted constructions or principles will be modified or departed from in a way that may be regarded generally as protecting the revenue or assisting the revenue.

This tendency is a matter for continuing concern, and it confirms reservations that were expressed when the income tax appeals jurisdiction was transferred from the Supreme Courts of the States to the Federal Court, which is of course a Commonwealth Court.

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<sup>80</sup>Ibid., pp. 617-618.

<sup>81</sup>Spry, *New Directions for Section 25: The Significance of Cooling's Case*, (1990) 19 Australian Tax Review, p. 160.

## CHAPTER IV

### THE SIGNIFICANCE OF *MYER* - PULLING TOGETHER THE THREADS

#### 1. INTRODUCTION

In this chapter concluding this section of the thesis, I review the principles from the *Myer*<sup>1</sup> case and how and to what the extent those principles have been applied in the subsequent cases.

#### 2. THE *MYER* DECISION

The Full Federal Court held the lump sum received by the taxpayer from the assignment of its right to receive interest under a loan constituted assessable income under section 25(1) and the second limb of section 26(a) of the Income Tax Assessment Act (1936).

The two strands or parts to the judgment are:

(1) ...a gain made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income.<sup>2</sup>

(2) If the lender sells his mere right to interest for a lump sum, the lump sum is received in exchange for, and ordinarily as the present value of, the future interest which he would have received. This is a revenue not a capital item - the taxpayer simply converts future income into present income.<sup>3</sup>

#### 3. THE FIRST STRAND OF THE *MYER* DECISION

##### (1) General

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<sup>1</sup>*F.C. of T. v. The Myer Emporium Ltd.* 87 A.T.C. 4363.

<sup>2</sup>*Ibid.*, p. 4365.

<sup>3</sup>*Ibid.*, p. 4371.

Their Honours in the High Court in *Myer* stated:<sup>4</sup>

Because a business is carried on with a view to profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income.

A business is carried on with the purpose of making a profit. Accordingly in respect of any gain made in the ordinary course of carrying on that business, the general profit-making purpose is inferred to the gain so made. Gains however that arise from an isolated or extraordinary transaction, i.e., a gain made otherwise than in the ordinary course of carrying on the business, do not carry the inference of a profit-making intent. This intention must be inferred from the transaction. The strength of the profit-making inference that is to be drawn from the transaction depends on the circumstances of the transaction.

The High Court in *G.P. International Pipecoaters Pty. Ltd. v. F.C. of T.*<sup>5</sup> referred to these circumstances as:<sup>6</sup>

- (a) "periodicity, regularity or recurrence"; or
- (b) "the character of the right or thing disposed of in exchange for the receipt", or
- (c) "the scope of the transaction, venture or business in or by reason of which money is received and by the recipient's purpose in engaging in the transaction, venture or business."

(2) Gains Made Otherwise than in the Ordinary Course.

Petroulias and Kenna<sup>7</sup> note the potential for the concept of income to be expanded in two ways as a result of the first strand. The first is the requirement for there to be a "profit-making intention". Such intention can be on a specific level or abstract level. Taken at an abstract level, the overall profit-making intention

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<sup>4</sup>Ibid., p. 4366.

<sup>5</sup>90 A.T.C. 4413.

<sup>6</sup>Ibid., p. 4420.

<sup>7</sup>Petroulias and Kenna, *Revenue Expansion: Income Concepts in the Post-Myer Era Part I: The Reach of the Doctrines*, (1992) 26 *Taxation in Australia*, No. 7, p. 365.

inferred from the business context in which a particular transaction takes place may be sufficient to render a gain from such a transaction assessable even if the gain is 'extraordinary'.

Petroulias and Kenna argue "there is potential to effectively imply a presumption that an 'extraordinary' gain will have been made with a profit-making intention and have an income quality. The result is that any gain made while in business may be income."<sup>8</sup> This is the line the Commissioner attempted to argue in *F.C. of T. v. Spedley Securities Ltd.*,<sup>9</sup> and which was firmly rejected in that case.

The second avenue of expansion they see is that in reality it is difficult to view extraordinary transactions as separate from the overall business context in which they occur. The line between transactions that occur in the ordinary course of business and "extraordinary" transactions is forever shifting. As was seen in *F.C. of T. v. G.K.N. Kwikform Services Pty. Ltd.*<sup>10</sup> the line can be hard to find. In that case the Court held that receipts from the non-return of hired equipment were assessable.

### (3) The "Broad Interpretation"

The "broadest interpretation" of *Myer* is that because a business is carried on to make a profit, any gain received in the course of the business activities is assessable within section 25(1) of the Australian Act. The only exception appears to be where: "a transaction is extraordinary, judged by reference to the course of carrying on the profit-making business, in which event the extraordinary character of the transaction may reveal that any gain resulting from it is capital, not income."<sup>11</sup>

Their Honours in *Myer* did not go on to elaborate on this point by way of example.

The Commissioner argued a broad interpretation of *Myer* in *Spedley*. The

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<sup>8</sup>Ibid., p. 365.

<sup>9</sup>88 A.T.C. 4126.

<sup>10</sup>91 A.T.C. 4336.

<sup>11</sup>87 A.T.C. 4363 at p. 4370.

Court rejecting this interpretation said:<sup>12</sup>

If the [Commissioner's] proposition were correct, it would mean that any receipt by a business would necessarily be of an income nature, and this would be contrary to authority, to the Act itself and to basic concepts concerning the distinction between capital and income.

The narrower view, as stated by *Hill J.* in *Westfield Ltd. v. F.C. of T.*<sup>13</sup> is:

When in *Myer* the High Court spoke of profits made in the ordinary course of business, their Honours were not speaking in a temporal sense. Rather, as the judgment of the Full Court of this court in *FC of T v Spedley Securities Limited* 88 ATC 4126 at 4130 points out, it is necessary that the purpose of profit-making must exist in relation to the particular operation.

In *Westfield* the sale of land to the A.M.P. for a profit was not assessable. The sale was not part of the taxpayer's ordinary business activity. At the time the land was acquired the subsequent resale to A.M.P. was a possibility open to it, although not its preferred option. The taxpayer therefore lacked the necessary profit-making purpose at the time the land was acquired.

In deciding that the profit was not assessable *Hill J.* reversed the decision of *Sheppard J.* *Sheppard J.* had taken a broad interpretation of *Myer*.

*Hill J.* in *Westfield* reaffirms the two-fold requirement that, where a transaction occurs outside the scope of ordinary business activities, it is necessary to find, not merely that the transaction is "commercial" but also, at the time the transaction is entered into, the intention or purpose of making a profit. In respect of there being a profit-making purpose, his Honour said:<sup>14</sup> "...where a transaction falls outside the ordinary scope of the business...there must exist, in my opinion, a purpose of profit-making by the very means by which the profit was in fact made."(emphasis added)

This can be contrasted with the decision of *Moana Sand Pty. Ltd. v. F.C. of T.*<sup>15</sup> where the payment made by the resuming authority was assessable to the

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<sup>12</sup>88 A.T.C. 4126 at p. 4130.

<sup>13</sup>91 A.T.C. 4234 at p. 4242.

<sup>14</sup>*Ibid.*, p. 4243.

<sup>15</sup>88 A.T.C. 4897.

taxpayer because the land resumed was purchased with a purpose of its ultimate sale. If *Hill J.*'s statement in *Westfield* were applied to the facts the payment may not have been assessable because the purpose of profit-making "by the very means by which the profit was in fact made" did not exist. It was intended at the date of acquisition that the land would be sold not resumed.

The decision of the Full Federal Court in *Henry Jones (IXL) Ltd. v. F.C. of T.*<sup>16</sup> is another rejection of this broad interpretation of the *Myer* decision.

In the Federal Court<sup>17</sup> *Sweeney J.* found that a lump sum received on the assignment of all rights under a licence agreement was assessable under section 25(1) and the second limb of section 26(a). In applying the *Myer* decision his Honour stated:<sup>18</sup>

The decision of the taxpayer to sell those rights to Citicorp was taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, in the context of carrying out a business operation or commercial transaction.

*Sweeney J.* applied a broad interpretation of *Myer* in the case.<sup>19</sup>

It is not necessary to be satisfied that the taxpayer had decided to assign the agreement to a particular company before it entered into the deal with Ardmona and SPC, but I have no hesitation in drawing the inference that before it entered into that deal it had decided that it would assign its rights under it to a bank or financial house in return for a lump sum payment.

From this there is an indication that *Sweeney J.*, as *Sheppard J.* had in *Westfield*, may have believed the High Court decision in *Myer* accepted that the profit-making requirement was less specific.

The Full Federal Court reversed the broad view taken by *Sheppard J.* *Hill J.* who gave the main judgment found that the first strand of the *Myer* decision did not apply to the facts before them.<sup>20</sup>

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<sup>16</sup>91 A.T.C. 4663.

<sup>17</sup>*Henry Jones (IXL) Ltd. v. F.C. of T.* 91 A.T.C. 4119.

<sup>18</sup>*Ibid.*, p. 4141.

<sup>19</sup>*Ibid.*, p. 4140

<sup>20</sup>91 A.T.C. 4663 at p. 4670.

While it must be accepted that in entering into the licence agreement the appellant did so with the intention of thereafter assigning the benefits of it to a bank or finance house, it would seem a misleading half-truth to say that its purpose of entering into the licence agreement was to realise the amount which it ultimately obtained from Citicorp.

(4) Conclusion

In conclusion, Petroulias and Kenna state:<sup>21</sup>

Outside the insurance cases, it seems the broad interpretation of *Myer* - that any gain in the course of business is prima facie income - has been denied. Therefore, the distinction between ordinary and extraordinary transactions becomes critical.

It would seem to follow that if a transaction is outside the ordinary course of business, then a specific profit-making intention is required.

(5) The concept of business

The greatest impact the *Myer* decision has had is perhaps in respect of the concept of 'business'. If a broad view is taken of what constitutes the ordinary course of business it is less likely that a receipt will fall outside the business of a taxpayer and be capital. After all the two-fold requirement of *Hill J. in Westfield* applies only where a transaction occurs outside the scope of ordinary business activities, and could be rendered redundant if a very broad view of the ordinary course of business is taken. A profit-making intention is automatically presumed for any transaction made in the ordinary course of a business.

Petroulias and Kenna note that even before *Myer* the authorities were beginning a "trend toward robust attitudes of what forms part of the ordinary course of business..."<sup>22</sup> One approach of this was viewing the existing business as expanding into other new areas. They give as examples, *Jennings Industries Ltd. v. F.C. of T.*<sup>23</sup> and *Kosciusko Thredbo P/L v. F.C. of T.*<sup>24</sup>

Even if such a trend had begun before *Myer*, that decision has brought a

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<sup>21</sup>Petroulias and Kenna, *Revenue Expansion: Income Concepts in the Post-Myer Era Part 1: The Reach of the Doctrines*, (1992) 26 *Taxation in Australia*, No. 7, p. 366.

<sup>22</sup>*Ibid.*, p. 367.

<sup>23</sup>84 A.T.C. 4288.

<sup>24</sup>84 A.T.C. 4043.



different focus on the concept of business and the extent of business activities. The effect has been in some of the cases including *Cooling* and *G.K.N. Kwikform*, to extend business far beyond what would previously have been embraced by the concept.

(a) The Myer Decision. If the loan agreement and assignment of interest were considered as separate and independent transactions, the High Court said:<sup>25</sup> "the [taxpayer's] argument that no relevant profit arose from the assignment had compelling force." However from Myer's point of view "the two transactions were essential and integral elements in an overall scheme, that scheme being a profit-making scheme."<sup>26</sup>

Petroulias and Kenna<sup>27</sup> criticise this statement: "It is a very selective use of facts to regard the creation and assignment of debt as a profit-making scheme without recognising them as part of a reorganisation of the Myer Group."

The High Court defined the scope of Myer's business in an ambiguous way:<sup>28</sup>

Myer's business at all relevant times was that of retailer and property developer. Before acquiring Myer Finance, Myer carried on business as a financier, though its business as a financier seems to have been confined to transactions relating to the Myer Group. The transactions in question here were entered into by Myer in the course of its business. The transactions, more particularly the assignment, were novel in the sense that it was the first time that Myer had entered into such an arrangement. But this fact does not take them out of the course of the carrying on of Myer's profit-making business.

Myer's business apparently was "of retailer and property developer" and "financier". While subsequent decisions treat *Myer* as deciding the transaction concerned was outside Myer's ordinary business activity (of retailing) there is an argument that the High Court may have even been prepared to treat the transaction as part of Myer's ordinary business activity.

(b) Post-Myer Decisions:

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<sup>25</sup>87 A.T.C. 4363 at p. 4370.

<sup>26</sup>*Ibid.*, 4370.

<sup>27</sup>Petroulias and Kenna, *Revenue Expansion: Income Concepts in the Post-Myer Era Part 1: The Reach of the Doctrines*, (1992) 26 *Taxation in Australia*, No. 7, p. 367.

<sup>28</sup>*Ibid.*, p. 4370.

(i) *F.C. of T. v. Cooling*.<sup>29</sup> In the case, *Hill J.* stated:

For the respondent it was submitted that the partnership business was the performance of professional services and not the receipt of incentive payments. In my view this submission, while in one sense true, disguises the true nature and extent of the firm's business. It is true that the firm's business includes the rendering of professional services but the firm does not cease business when it moves from one set of leased premises to another...

Where a taxpayer operates from leased premises, the move from one premises to another and the leasing of the premises occupied are acts of the taxpayer in the course of its business activity just as much as the trading activities that give rise more directly to the taxpayer's assessable income.<sup>30</sup>(emphasis added)

*Hill J.* commented the evidence suggested in Queensland in 1985 lease incentives were "an ordinary incident of leasing premises in a new city building." His Honour appeared to believe because incentives were common, this supported his above finding.

As previously discussed, by so holding, Mr Justice *Hill* apparently extends the concept of the business of a firm of solicitors to include the moving from and to leased premises and the leasing of such premises.

Petroulias and Kenna comment,<sup>31</sup> in respect of the lease incentive being in the ordinary course of business:

When these views are contrasted with the quasi-test in *Myer* - that the transaction be 'judged by reference to the transactions which the taxpayer usually engages' - it seems the concept of ordinary course of business has expanded into territory that once would have been considered 'extraordinary'.

(ii) *F.C. of T. v. G.K.N. Kwikform Services Pty. Ltd.* In this case it was critical if the gain was to be assessable to the taxpayer that it be found to be an ordinary incident of its business. This was because the taxpayer did not enter into each hiring contract with the intention of making a profit when hire equipment was not returned.

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<sup>29</sup>90 A.T.C. 4472.

<sup>30</sup>*Ibid.*, p. 4484.

<sup>31</sup>Petroulias and Kenna, *Revenue Expansion: Income Concepts in the Post-Myer Era Part 1: The Reach of the Doctrines*, (1992) 26 *Taxation in Australia*, No. 7, p. 368.

In the case *Davies J.* said:<sup>32</sup>

In [GKN] Services' case, profit-making resulting from the enforcement of the compensation clause was a regular incident of Services' business of hiring out scaffolding...

and

...so, in the present case, it is crucial that the non-return of scaffolding was a regular, expected and ordinary incident of Services' business and that the profits derived therefrom. (emphasis added)

The distinction between transactions that normally would be considered to be in the ordinary course of business and those considered as "extraordinary" transactions in this case have become blurred. The taxpayer was in the business of hiring out scaffolding equipment not the making of a profit from its non-return. The receipts from the non-return of equipment after all amounted to no more than 5.7% of the total receipts in the years in question.

An additional point is, their Honours in the Full Federal Court regarded the hire contract as determining the scope of business. In the court below *Foster J.* had assumed that on making the equipment available the taxpayer had performed its obligations. The Full Federal Court however implied that the taxpayer had not performed all its obligations until the contingencies under the contract have been fulfilled.

(iii) *G.P. International Pipecoaters Pty. Ltd. v. F.C. of T.* In respect of the establishment costs paid to the taxpayer the Court held:<sup>33</sup> "It is impossible to treat the business of the taxpayer as limited to the coating of the pipe when the construction of the pipe-coating plant was an integral part of the work which the taxpayer was bound to perform."

The taxpayer's activity corresponded with the contract with the Energy Commission. It was on this contract that the Court based its decision (as in *G.K.N. Kiwiform*).

The taxpayer referred to two cases, one of which was the English case of

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<sup>32</sup>91 A.T.C. 4336 at p. 4338.

<sup>33</sup>90 A.T.C. 4413.

*Boyce v. Whitwick Colliery Co. Ltd.*<sup>34</sup> In that case, a colliery company agreed with a District Council to install plant and equipment to pump water out of its mine, filter it, and supply it to the council's system. The council specified the plant and equipment to meet its needs and entered into a contract with the company agreeing to pay each year one-thirtieth of the cost outlaid by the company in installing the plant and equipment. The council also agreed to other charges including one penny per thousand gallons of water supplied. It was held the payments of one-thirtieth of the cost outlaid in plant and equipment installation were of a capital nature.

The full High Court in *G.P. International Pipecoaters* was critical of this decision, stating:<sup>35</sup>

If the Court in *Boyce* declined to treat the receipts there in question as income because they did not arise from the company's trade as the operator of a colliery, the decision failed to recognise the company's trade in supplying water. The receipts appear to have been received in the ordinary course of the company's business of supplying water.

If the facts of *Boyce* had come before their Honours they would have extended the business of the colliery to include the supply of water and treated the payments as assessable income of that business. Their Honours' statement in *G.P. International Pipecoaters* shows how far the Australian courts have moved from earlier decisions.

(iv) *Westfield Ltd. v. F.C. of T.* In this case the Court took a more restrictive view of the taxpayer's business activity.

In reviewing the cases *Hill J.* states:

It does not, however, follow from the judgment in *Myer*, or for that matter, from the judgments in any later cases, that every profit made by a taxpayer in the course of his business activity will be of an income nature. To so express the proposition is to express it too widely, and to eliminate the distinction between an income and a capital profit.<sup>36</sup>

His Honour gives the example of a taxpayer carrying on a business who may sell its headquarters so it can move to larger premises and makes a profit over

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<sup>34</sup>[1934] All E.R. 706.

<sup>35</sup>90 A.T.C. 4413 at p. 4424.

<sup>36</sup>91 A.T.C. 4234 at pp. 4241-4242.

historical cost. The transaction of sale may arise in the ordinary course of the taxpayer's business, but that profit ordinarily will not be income, particularly where at the time of acquisition there was no intention or purpose of making a profit by sale of the premises when they became too small.

*Hill J.* also comments:<sup>37</sup> "...this court in *FC of T v Spedley Securities Limited* 88 ATC 4126 at 4130 points out, it is necessary that the purpose of profit-making must exist in relation to the particular operation".

Applying these principles to the case at hand his Honour found:

It cannot be said, in the present case, that resale of land was part of the ordinary business activity at all, or, for that matter, a necessary incident of that business activity. That business activity was relevantly the construction of shopping centres, their leasing or management, either on the appellant's own land, on the land of others, or on joint venture land.<sup>38</sup>

His Honour in reversing *Sheppard J.*'s finding defined more narrowly the taxpayer's business.

(v) *F.C. of T. v. Hyteco Hiring Pty. Ltd.* This appeal from the decision of *Beaumont J.* concerned the assessability of profits made by a forklift hiring company from the sale of forklifts that were no longer suitable for hire.

Again *Hill J.* reversed the decision of the lower court, this time of *Beaumont J.* He found on the basis of the evidence it would have been erroneous to characterise the business as both the hiring of forklift trucks and the sale of the trucks. The trucks were purchased for the purpose of being leased out, not for resale. This was so even though the sale of trucks that were no longer suitable for leasing was inevitable, or, at least, the only alternative to scrapping them at the end of the useful life.

In this case the Court took a more narrow view of the business activities of the taxpayer than has been taken in some of the other decisions.

(c) Conclusion - The Concept of Business.

(i) *Myer* has extended the concept of business.

(ii) Cases such as *Cooling* and *G.K.N. Kwikform* are evidence of this and

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<sup>37</sup>*Ibid.*, p. 4242.

<sup>38</sup>*Ibid.*, p. 4242.

show the line between transactions in the ordinary course of business and other "extraordinary" transactions can become very blurred.

(iii) There are however a number of cases, for example, *Westfield* and *Hyteco* where the Court has taken a more restrictive view of the business activities of the taxpayer.

(iv) It is now crucial for advisers to make a detailed examination of the taxpayer's business. On this point Petroulias and Kenna observe:<sup>39</sup>

Simple transactions should be considered. In *G.P. International Pipecoaters*, a simple sale of the plant, we are told, would have avoided the receipt being income; that is, if the establishment costs had been received as the price of sale of the plant which the taxpayer had erected for its own purposes.

In *Kwikform*, *Beaumont J.* implies likewise.

#### 4. THE SECOND STRAND OF THE *MYER* DECISION

I propose to comment briefly on the second strand of the *Myer* decision as it is of less significance to the scope of this thesis and is only an issue in *Myer* and *Henry Jones*.

To recapitulate, the second strand in *Myer* is:

If the lender sells his mere right to interest for a lump sum, the lump sum is received in exchange for, and ordinarily as the present value of, the future interest which he would have received. This is a revenue not a capital item - the taxpayer simply converts future income into present income: see *Commissioner of Internal Revenue v P.G.Lake, Inc.* (1958) 356 US 260 at pp 266-267. By a transaction consisting in the making of a loan and a sale of the right to interest on the money lent, the lender acquires at once a debt and the price which the sale of the right has fetched. The price of the right is the lender's compensation for being kept out of the use and enjoyment of the principal sum during the period of the loan and, like the interest for which it is exchanged, it is a profit.<sup>40</sup>

Petroulias and Kenna<sup>41</sup> state a problem in applying the above principle to be that it does not necessarily follow that "compensation for being kept out of the use

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<sup>39</sup>Petroulias and Kenna, *Revenue Expansion: Income Concepts in the Post-Myer Era Part 1: The Reach of the Doctrines*, (1992) 26 Taxation in Australia, No. 7, p. 375.

<sup>40</sup>87 A.T.C. 4363 at pp. 4371-4372.

<sup>41</sup>Petroulias and Kenna, *Revenue Expansion: Income Concepts in the Post-Myer Era Part 1: The Reach of the Doctrines*, (1992) 26 Taxation in Australia, No. 7, p. 372.

and enjoyment of the principal sum" is income because the substitute may not be in an income form. When a loan is made and a right to interest obtained, no income has been derived at that stage. No interest (and income) is derived unless and until broadly the interest is received (or there is a right to recover interest not paid but due). Until such time the interest cannot be characterised as income. They believe that there is a gap in the logic of the High Court by treating the loss of enjoyment of something that is not yet income as being income.

This they say can be contrasted to *Commr. of Taxes (Vic.) v. Phillips*<sup>42</sup> and *F.C. of T. v. Dixon*.<sup>43</sup>

In *Phillips* case, the taxpayer was employed as the governing director of a company. His contract specified his term to be of ten years' duration and his remuneration to be 12.5% of the net profits of the company. The company disposed of its business. Mr Phillips' services were dispensed with. Following an agreement with him the company paid as compensation 12.5% of the estimated net profits of the remaining part of the ten year term, in monthly instalments. The monthly payments were held to be of an income nature.

Petroulias and Kenna in respect of *Phillips* (and *Dixon*) note the regular payments received were found to be income because they were in substitution for other regular payments that were in an income form.

They also note an inconsistency in *Myer*. In the case their Honours specifically made a distinction in respect of consideration received on the assignment of a contractual right to receive an annuity. Such consideration was not income. The inconsistency arises because the substantive approach per *Commissioner of Internal Revenue v. P.G. Lake, Inc.*,<sup>44</sup> would suggest the taxpayer receives annuity payments in respect of a right to receive income. On this reasoning, they argue, the assignment of a right to an annuity should render all the consideration income in that year.

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<sup>42</sup>(1936) 55 C.L.R. 144.

<sup>43</sup>(1952) 86 C.L.R. 540.

<sup>44</sup>(1958) 356 U.S. 260.

The note of caution in *Phillips'* case should also be remembered: "It is true that to treat a sum of money as income because it is computed or measured by reference to loss of future income is an erroneous method of reasoning..."<sup>45</sup>

In *Henry Jones (IXL) Ltd.*, *Sweeney J.* in the Federal Court relied on the substantive approach used by the US Supreme Court in *P.G. Lake. Hill J.* in the Full Federal Court stated:<sup>46</sup>

Notwithstanding some doubt. I think *Myer* must be taken as establishing that, except in the case of the establishment of an annuity where the income arises from the very contract assigned, an assignment of income from property without an assignment of the underlying property right will, no matter what its form, bring about the result that the consideration for that assignment will be on revenue account, as being merely a substitution for the future income that is to be derived. Thus, the fact that the future income may be secured by an agreement, and that the assignment is of the right title and interest of the assignor in that agreement will not affect the result. (emphasis added).

and

Amounts received as compensation for an income right, amounts which thus fill the hole of income, have the character of income.

## 5. A PROFIT-MAKING PURPOSE

The High Court in *Myer* stated:<sup>47</sup>

...it is well settled that a profit or gain made in the ordinary course of carrying on a business constitutes income... Because a business is carried on with a view to profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income. (emphasis added)

Accordingly if a profit or gain is made in the ordinary course of carrying on a business, it is automatically presumed that there is a profit-making purpose in respect of that profit or gain.

The Full Federal Court however in *Spedley*<sup>48</sup> states that: "The purpose of

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<sup>45</sup>(1936) 55 C.L.R. 144 at p. 156.

<sup>46</sup>91 A.T.C. 4663 at p. 4675.

<sup>47</sup>87 A.T.C. 4363 at p. 4366.

<sup>48</sup>88 A.T.C. 4126 at p. 4130.



profit-making must exist in relation to the particular operation."

This appears contrary to *Myer*. Where a profit is made in the ordinary course of a business activity, applying *Spedley*, does a specific profit-making intention in respect of that particular operation have to exist?

Mr Justice *Hill* picks up on this in *Westfield* referring to the above passage in *Spedley*, and adding:<sup>49</sup>

In a case where the transaction, which gives rise to the profit, is itself a part of the ordinary business...the identification of the business activity itself will stamp the transaction as one having a profit-making purpose... The profit-making purpose can be inferred from the association of the transaction of purchase and sale with that business activity.

This appears to support the approach in *Myer*. However a little earlier in his judgment Mr Justice *Hill* gives the following example (noted earlier) which appears to endorse the approach in *Spedley* i.e., a profit-making purpose must exist in respect of the particular operation.<sup>50</sup>

A taxpayer carrying on a business might sell its headquarters in order to move to larger premises and make a profit over historical cost. The transaction of sale may be one which arises in the ordinary course of the taxpayer's business, but that profit will not ordinarily be income, particularly where, at the time of acquisition of the site, there was no intention or purpose of profit-making by sale when the premises became too small. (emphasis added)

In trying to reconcile the apparent inconsistency Petroulias and Kenna in discussing this whole area suggest:<sup>51</sup>

What Hill J seems to suggest is that within the concept of the ordinary course of business (where he still requires an intention to profit to be shown) there is a notion of 'part of the ordinary business' where the profit-making intention is imported automatically.

Reconciliation of this prima facie inconsistency may be found by recognising that Hill J's concept of 'ordinary course of business' is beyond the contemplation of prior authorities.

It is Hill J's 'part of the business' which equates with what prior authorities would regard as 'the ordinary course of the business' over a much greater time frame. For instance, a company's expanding and acquiring of new premises

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<sup>49</sup>91 A.T.C. 4234 at p. 4242.

<sup>50</sup>*Ibid.*, p. 4242.

<sup>51</sup>Petroulias and Kenna, *Revenue Expansion: Income Concepts in the Post-Myer Era Part 1: The Reach of the Doctrines*, (1992) 26 *Taxation in Australia*, No. 7, p. 374.

would be in the ordinary course of business, in Hill J's view.

They note that included in the application of *G.K.N. Kwikform* for special leave to appeal to the High Court was the question whether there is a requirement for an intention to make a profit in the ordinary course of business. The C.C.H. publication "*Australian Tax Cases 1991 - AAT & Courts*"<sup>52</sup> states: that the taxpayer has in fact been refused special leave to appeal to the High Court.

## 6. TRADITIONAL FACTORS INDICATING INCOME

Their Honours in the Full High Court in *G.P. International Pipecoaters Pty. Ltd. v. F.C. of T.* comment:<sup>53</sup>

To determine whether a receipt is of an income or of a capital nature, various factors may be relevant. Sometimes, the character of receipts will be revealed most clearly by their periodicity, regularity or recurrence; sometimes, by the character of a right or thing disposed of in exchange for the receipt; sometimes, by the scope of the transaction, venture or business in or by reason of which money is received and by the recipient's purpose in engaging in the transaction, venture or business.

Where a profit or gain is made from a transaction which is not in the ordinary course of the business activity of the taxpayer, the intention to make a profit must be inferred from the transaction itself. The strength of the inference of profit-making that can be drawn from the transaction will be influenced by factors such as periodicity, regularity and recurrence. With the courts increased attention on the nature of the business these other factors are assuming less importance.

If a court treats the requirement for there to be a profit-making intention at an abstract level, the profit-making intention inferred from the overall business context in which transactions occur, could render gains which would usually be viewed as extraordinary in nature as being income and assessable. In such instance factors such as the periodicity of the receipt will play little part.

The indicator of periodicity, regularity and recurrence however still does play

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<sup>52</sup>1992 C.C.H. Australia Ltd. at xvii.

<sup>53</sup>90 A.T.C. 4413 at p. 4420.

some part. Petroulias and Kenna<sup>54</sup> refer to *Moneyman Pty. Ltd. v. F.C. of T.*<sup>55</sup> as an example. In *Moneyman* the taxpayer sought to depart from the wholesale milk business and sold its assets. One of the assets owned was a right to sell milk on favourable terms to a distributor for 20 years. The purchaser in return for the purchase of this right was to make monthly payments based on one-seventh of the current price of retail milk applied to a deemed quantity of milk per day. Accordingly the payments were calculated independently of the milk that was actually delivered. After the right was sold the purchaser merged with the distributor, so there was no actual supply of milk. The payments continued to be made to the taxpayer. In deciding the payments were income Gummow J. said the receipts had the characteristics of periodicity, regularity and recurrence.

Perhaps the last word on this point is from the High Court in *Myer*.<sup>56</sup>

The periodicity, regularity and recurrence of a receipt has been considered to be a hallmark of its character as income in accordance with the ordinary concepts and usages of mankind. Likewise, the need to distinguish capital and income for trust purposes and other purposes has focused attention on the difference between the right to receive future income and the receipt of that income, a difference which has given rise to the analogical difference between the fruit and the tree...

and

...valuable though these considerations may be in categorizing receipts as income or capital in conventional situations, their significance is diminished when the receipt in question is generated in the course of carrying on a business, especially if it should transpire that the receipt is generated as a profit component of a profit-making scheme. If the profit be made in the course of carrying on a business that in itself is a fact of telling significance. It does not detract from its significance that the particular transaction is unusual or extraordinary, judged by reference to the transactions in which the taxpayer usually engages, if it be entered into in the course of carrying on the taxpayer's business.

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<sup>54</sup>Petroulias and Kenna, *Revenue Expansion: Income Concepts in the Post-Myer Era Part 2: Traditional Indicia of Income*, (1992) 26 *Taxation in Australia*, No. 8, p. 427.

<sup>55</sup>91 A.T.C. 4019.

<sup>56</sup>87 A.T.C. 4363 at p. 4370.

LEASING INCENTIVES - TAX TRAPS FOR TENANTS

Inducements catch taxman's eye

Tax net closes  
on leasing lures

*Lease inducements under investigation*

The tax treatment of  
lease incentives — a  
looming battle?

Price Waterhouse 'paid \$1m rental inducement'

**Inducements can  
be 'tax effective'**

**Watch Step with Lease Incentives**

## PART C

### THE TAX TREATMENT OF LEASE INCENTIVES IN NEW ZEALAND

#### INTRODUCTION

In recent years it has been common commercial practice for lessors to offer to prospective tenants an incentive to induce the tenants to enter into a lease. The incentive may take any one of a number of forms:

- (1) A lump sum upfront cash payment.
- (2) A rent free period (a rent holiday).
- (3) A rent discount.
- (4) A free-fit out of the premises.
- (5) An interest free loan by the lessor.
- (6) Free holidays.
- (7) Free equipment such as computers and desks.
- (8) Payment of removal/relocation costs.
- (9) Payment of the surrender value of the existing lease of the prospective lessee.
- (10) The provision of items such as cars, boats, paintings and other benefits.

It is considered that such incentives are generally non-taxable on the basis that they are capital in nature, at least this was the view until the decision of the Full Federal Court in *F.C. of T. v. Cooling*.<sup>1</sup> This case has now raised the issue of whether inducements do in fact constitute a capital or income receipt.

The Inland Revenue Department (I.R.D.) are well aware of this issue and no doubt, at some stage, would like to follow the Australian example. In late 1991 the I.R.D. forwarded letters to property owners, managers and real estate agents

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<sup>1</sup>90 A.T.C. 4472.

requesting they supply information on incentives provided over the previous financial year, including the names and addresses of the parties involved.<sup>2</sup> "The letter although innocuously worded, must be taken seriously in light of recent Australian developments - particularly the decision in *F.C. of T. v. Cooling*...and income tax ruling IT2631..."<sup>3</sup> I personally have also seen letters sent to lessees by the I.R.D. concerning such incentives.

The Inland Revenue Commissioner, David Henry, has stated the demand for information to be just part of a general tax audit. "The commission has a statutory function and responsibility to check tax returns and how people have treated various types of income".<sup>4</sup>

He also stated that:

...it was the first time in his three years as Commissioner that the department had undertaken such an audit. He said so far only some of the 15 companies surveyed had responded, some had requested more time and 'a handful' had sought legal advice.

The results of this first audit would determine whether the issue was to be taken further, he said.<sup>5</sup>

It appears the Commissioner is empowered to collect such information under section 17 of the Inland Revenue Department Act. Failure to comply with the request is an offence. Only legal advice given to clients is exempt. The far reaching powers of the Commissioner to look into private business deals was recently upheld by the Privy Council in *New Zealand Stock Exchange v. C. of I.R.*, *The National Bank of New Zealand Ltd. v. C. of I.R.*<sup>6</sup>

In *The Press*<sup>7</sup> in February 1992, the Department's director, taxpayer audit, Ms Joy Hames was reported as stating:

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<sup>2</sup>*The National Business Review*, October 4, 1991, p. 1.

<sup>3</sup>Smith, *The Tax Treatment of Lease Incentives - A Looming Battle?*, (1992) CCH New Zealand Business Bulletin, No. 2, p. 9.

<sup>4</sup>*The National Business Review*, October 4, 1991, p. 1.

<sup>5</sup>*Ibid.*, p. 6.

<sup>6</sup>(1991) 13 N.Z.T.C. 8147.

<sup>7</sup>*The Press*, February 10, 1992.

The department intended to issue guidelines on the proper tax treatment of the inducements so taxpayers could comply with the law. However, it was not known when these would be available.

If the department then became aware that there was a compliance problem, it could start a project to look into that, but this was still hypothetical, she said.

To date (November 1993) no guidelines have been issued. According to the Tax Education Office no Taxation Information Bulletin will be published by the I.R.D. on this issue.<sup>8</sup> The only guideline is that provided in a Tax Education Office newsletter:<sup>9</sup> "The IRD have noted the view that inducement payments are considered on a case by case basis, although this has tended to result in the receipt being regarded as revenue in nature and therefore assessable income."

Concerns raised about the assessability of incentives since *Cooling* have impacted on the types of incentives currently being provided. Free fit-outs are now the preferred option over cash incentives.<sup>10</sup> Frigate Aubrey, Registered Valuers and Property Consultants<sup>11</sup> comment as follows:

Tenants entering into new leases now prefer to pay true market rental rather than inflated rentals in return for inducement packages. There remains concern that the Inland Revenue Department may classify some inducement packages as income...

Free fit-out is now almost a mandatory request and now commonly accepted by building owners if the lease term is at least six years.

While this was written in respect of the Christchurch commercial rental scene, it is likely that it applies to other New Zealand centres to a greater or lesser degree.

Given the widespread practice of providing lease incentives and in many cases the large sums involved, it is almost certain the matter at some stage will find itself in the courts. In Australia it is estimated *Cooling* and the income tax ruling have brought in \$A100 million into the coffers of the Government. And as can be

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<sup>8</sup>Tax Education Office seminar, "Facts on Tax" November 1993.

<sup>9</sup>Tax Education Office 41, 20 June 1991, p. 2.

<sup>10</sup>*The Press*, February 10, 1992.

<sup>11</sup>"Investment Review" February 1993.

seen from the few headlines photocopied the issue is very topical at present.

This part of the thesis therefore looks at the possible tax treatment of lease incentives in the hands of the lessee by examining sections of the Income Tax Act that may be applicable, the approach of the Australian Commissioner in income tax ruling IT2631, several New Zealand cases that discuss the capital and income distinction and several Canadian decisions on the point. Brief comment is also made on whether a lessor will be allowed a deduction for the costs of providing a lease incentive.



## CHAPTER I

### **SECTION 65(2) OF THE INCOME TAX ACT**

#### INTRODUCTION

As previously stated, section 65(2) provides that certain categories of receipts are included within the term "assessable income". There are three specific subsections which could apply to the provision of a lease inducement. These subsections have wide application and bring to tax profits and gains derived from many varied transactions. The subsections are (a),(e) and (l) of section 65(2) and will be discussed in that order.

## 1. SECTION 65(2)(a)

Section 65(2)(a) provides that the assessable income of any person shall include: "All profits or gains derived from any business (including any increase in the value of stock in hand at the time of the transfer or sale of the business, or on the reconstruction of a company)".

The term "business" is defined in section 2 to include: "any profession, trade, manufacture, or undertaking carried on for pecuniary profit".

For a lease incentive to be assessable to the recipient under this subsection it would have to be received in the course of or as part of the taxpayer's business. In *F.C. of T. v. Cooling*,<sup>1</sup> as we have already seen, *Hill J.* stated:<sup>2</sup>

Where a taxpayer operates from leased premises, the move from one premises to another and the leasing of the premises occupied are acts of the taxpayer in the course of its business activity just as much as the trading activities that give rise more directly to the taxpayer's assessable income.

### (1) Issue

Would a lessee's business be so broadly defined in New Zealand that it would include receiving a lease incentive? Is the New Zealand case law any different from Australian authorities on the definition of business? What approach do the New Zealand courts generally take in applying the subsection?

### (2) The New Zealand Cases

It should be noted a large proportion of the New Zealand cases on section 65(2)(a) deal with whether or not a business activity is in existence rather than what is the actual nature of the taxpayer's business.

The leading case on what constitutes a business is *Grieve v. C. of I.R.*<sup>3</sup> in which the appellants had to prove that their farming activities were a business. The Court held the appellants' activities did constitute a business. On so deciding,

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<sup>1</sup>90 A.T.C. 4472.

<sup>2</sup>*Ibid.*, p. 4484.

<sup>3</sup>(1984) 6 N.Z.T.C. 61,682 (C.A.).

*Richardson J.* embarked on a thorough analysis of what was meant by the term "business" in the context of the Act. His Honour concluded that whether or not a taxpayer is in business is a twofold inquiry as to:

- (a) the nature of the activities carried on (which must amount to a profession, trade, manufacture or undertaking); and
- (b) the intention of the taxpayer in engaging in those activities.

*Richardson J.* stated that underlying the term "business" was the fundamental notion of the exercise of an activity in an organised and coherent way and one which was directed to an end result.

Concerning the intention of the taxpayer, a number of matters may be considered including statements by the taxpayer; the nature of the activity; the scale of operations and the volume of transactions; the commitment of time, money and effort; the pattern of activity; and the financial results.

The taxpayer must also intend to gain a pecuniary profit, that is, a profit, in money or money's worth that is to be ascertained on ordinary commercial principles which affect the type of undertaking in question.

### (3) The Approach in Australia

The Australian Income Tax Assessment Act 1936 defines in section 6 a business to include "any profession, trade, employment, vocation or calling, but does not include occupation as an employee".

The following factors were regarded as important in deciding whether a given enterprise was a "business" for the purpose of the Act in *Ferguson v. F.C. of T.*<sup>4</sup> by *Bowen C.J. & Franki J.*:

- (a) the nature of the activities, particularly whether the activities had the purpose of profit-making;
- (b) the repetition and regularity of the activities;
- (c) the organisation of the activities in a businesslike manner, the keeping of books, records and the use of a system; and

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<sup>4</sup>79 A.T.C. 4261.

- (d) the volume of operations and the amount of capital that was employed.

These points are similar to those detailed by *Richardson J.* in *Grieve*. *Richardson J.* in *Grieve* commented in respect of the Australian cases that the Australian definition does not make reference to "for pecuniary profit" or a similar expression. Accordingly, he said:<sup>5</sup> "for that reason the Australian authorities must be read with some care."

(4) Specific Points on Section 65(2)(a):

(a) In *C. of I.R. v. City Motor Service Ltd.*; *C. of I.R. v. Napier Motors Ltd.*,<sup>6</sup> discussed later, *Turner J.* in the Court of Appeal stated in respect of the predecessor to section 65(2)(a):

...in the words 'from the business' of the company something more is meant than merely 'as a result of the fact that the company was carrying on this business'. I think that *from the business* must mean *from the current operations of the business*.<sup>7</sup>

and:

[The words] are not, in my opinion, apt to included accretions to the capital assets of the taxpayer which, although they may result from the fact of his carrying on business, yet do not arise from the actual current operations of that business.<sup>8</sup>

*Turner J.* drew support from the judgments of the majority of the High Court of Australia in *Dickenson v. F.C. of T.*<sup>9</sup> The case concerned two cash payments made to a station-owner who bound himself to only sell the products of the oil company making the payments. In the course of his judgment *Dixon C.J.* stated:<sup>10</sup>

There is nothing recurrent in the nature of the payment. It is not a normal or actual incident of carrying on such a business and it does not represent a purpose for which such a business is carried on. I think therefore that the sum ought not to be treated as a profit of the existing business.

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<sup>5</sup>(1984) 6 N.Z.T.C. 61,682 at p. 61,690.

<sup>6</sup>[1969] N.Z.L.R. 1010.

<sup>7</sup>*Ibid.*, p. 1017.

<sup>8</sup>*Ibid.*, p. 1018.

<sup>9</sup>(1958) 98 C.L.R. 460.

<sup>10</sup>*Ibid.*, p. 475.

(b) The subject-matter in a transaction is important. The nature and the quantity of the subject-matter dealt with may indicate that the transaction is a trade transaction.

In *Rutledge v. I.R. Commrs.*<sup>11</sup> a taxpayer who purchased and sold a million rolls of toilet paper was held by the Court to be engaged in a transaction in the nature of trade by virtue of the nature and quantity of the subject matter. The concept of an adventure in the nature of trade was discussed in the context of the *Myer*<sup>12</sup> decision.

(c) Isolated Transactions. There can be a finding that a business is being carried on even though there is an isolated transaction. Generally however, a business will involve a frequency or repetition of transactions.

A large number of the English cases which are generally cited as showing that an isolated transaction can be subject to income tax, do so by holding the transaction concerned to be an adventure in the nature of a trade.

In New Zealand a number of cases have held a business to be in existence when a single transaction is involved, for example *C. of T. v. Miramar Land Co. Ltd.*<sup>13</sup> The taxpayer company was formed with the principle object of acquiring a block of land in Wellington to subdivide. Some five months later and before any development work had taken place the land was resold at a profit. The Court of Appeal held that the business was incorporated for the purpose of dealing in land. Accordingly that was its ordinary business.

(d) Sale of Investments. A profit made from the sale of property which is not trading stock will normally constitute assessable income where the sale occurs as part of the carrying on of the normal business operations. As discussed in respect of the Australian decisions, it is therefore crucial to determine whether a particular realisation is actually part of the carrying on of a business.

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<sup>11</sup>(1929) 14 T.C. 490.

<sup>12</sup>*F.C. of T. v. The Myer Emporium Ltd.* 87 A.T.C. 4363.

<sup>13</sup>(1906) 26 N.Z.L.R. 723.

The leading case stating this principle is *Californian Copper Syndicate Ltd. v. Harris*<sup>14</sup> which was discussed earlier in the context of the Australian cases.

Lord *MacDonald* in that case said in respect of a gain so made:<sup>15</sup> "Is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?".

In respect of banks and insurance companies it is now settled law that any profit or loss that is incurred in disposing of shares and other readily saleable securities should generally be taken into account in calculating the assessable income of that bank or insurance company. The conventional structure of these companies involves the investing of funds in a portfolio of securities that can be readily realised. The idea underlying the portfolio is that there is a reserve which can be drawn upon in times of emergency. In addition to times of emergency, changes in the constitution can occur when an investment policy requires a switch to a better security. Any profit on sale is assessable, as it is regarded as resulting from what is truly an act done in the carrying on of the business of the bank or insurance company. However there are some exceptions in the cases; for example, *State Insurance Office v. C. of I.R.*<sup>16</sup>

#### (5) Inducement Received as Part of Lessee's Business?

Could the receipt of a lease incentive constitute part of the business of the lessee and accordingly be assessable under section 65(2)(a)?

(a) The City Motor's Case. As already mentioned Mr Justice *Turner* in the *City Motor's* case stated in respect of the predecessor to section 65(2)(a) that "from the business" meant more "than merely 'as a result of the fact that the company was carrying of this business' ". The phrase meant "from the current operations of the business."

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<sup>14</sup>(1904) 5 T.C. 159.

<sup>15</sup>*Ibid.*, pp. 156-166.

<sup>16</sup>(1990) 12 N.Z.T.C. 7035.

Most lease incentives will arguably be received by a lessee as a result of the lessee carrying on a business. As a result of that business the taxpayer requires space from which to carry on its business. In seeking space an incentive to enter a lease may be offered.

The incentive is not derived from the current operations of the lessee's business. The current operations of the lessee's business will in the case of a solicitor for example, be the provision of legal services not the receipt of a lease incentive. In addition, the incentive will not be received in return for professional services performed by the solicitor.

In the words of *Dixon C.J.* in *Dickenson v. F.C. of T.* the receipt of a lease incentive "is not a normal or actual incident of carrying on ...[the lessee's] business and it does not represent a purpose for which such a business is carried on."<sup>17</sup>

In *Cooling*, *Hill J.* placed some reliance for his finding on the fact that incentive payments were an ordinary incident of leasing premises in a new building in Queensland at that time.

Lease incentives have also been a common feature of leasing premises in New Zealand. However the fact that it is common for incentives to be offered does not mean the incentive is "a normal or actual incident of carrying on [the lessee's] business." The receipt of an incentive will not after all "represent a purpose for which such a business is carried on".

(b) The *State Insurance* case and other cases indicate there must be a close nexus between the receipt in question and the business of the taxpayer. The Court in *State Insurance* held that profits derived from the exchanging of shares were not taxable as there was no nexus between the realisations with which the case was concerned and the method of operation of the business.

Expressed another way, the Court in *F.C. of T. v. Reynolds*<sup>18</sup> stated: "In the case of a taxpayer conducting a business, if the receipt is as a matter of reality part of

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<sup>17</sup>(1958) 98 C.L.R. 460.

<sup>18</sup>(1981) 11 A.T.R. 629.

the proceeds of a business or a product of or incidental to the conduct of a business, it is usually income".

An inducement will generally not have the necessary close relationship with the business of the lessee. The only relationship will be that the lessee's business is carried on from (leased) premises the subject of an incentive.

(c) In the High Court decision of *John Anderson Ltd. v. C. of I.R.*,<sup>19</sup> Henry J. distinguished *City Motor's* and other such cases on the basis that they concerned an asset owned by the taxpayer which had acquired an increase in value. In *John Anderson* however there was no such asset. The case concerned a transport operator who entered into a lease agreement with a finance company for the lease of a truck. As the truck neared the end of its useful life the finance company sold it in excess of its residual value. The taxpayer received a sum as profit. The High Court held that the profit was assessable under section 65(2)(a). The leasing of a vehicle as well as its use "was incidental in a real way to the business of transporting goods".

The profit was also income according to ordinary concepts.

It may be argued on the basis of this case that the principles enunciated at (a) in *City Motor's* and other cases do not apply in respect of the lease of an asset.

(d) *C. of I.R. v. Stockwell*.<sup>20</sup> It had been suggested by commentators that the New Zealand courts and Taxation Review Authority had been adopting a wider view of when a business existed in the cases on share dealing and deductibility of losses. The recent Court of Appeal decision of *C. of I.R. v. Stockwell* concerning the deductibility of share losses however does not support this. The Court of Appeal commented that the T.R.A. had applied too liberal a test in concluding the taxpayer was in the business of dealing in shares. It would appear a more substantial structure will need to exist before there is a "business".

(e) There have been no indications as yet that the principles in *Myer* and *Cooling* will cross the Tasman Sea. In recent cases concerning the distinction

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<sup>19</sup>(1985) 7 N.Z.T.C. 5029.

<sup>20</sup>(1992) 14 N.Z.T.C. 9190.



between income and capital such as *Thomas Borthwick*<sup>21</sup> discussed later, the courts have based their decisions on an analysis of the traditional cases.

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<sup>21</sup>*C. of I.R. v Thomas Borthwick & Sons (Australasia) Ltd.* (1992) 14 N.Z.T.C. 9101.

## 2. SECTION 65(2)(e)

Could a lease incentive received by a lessee be assessable under this provision?

### (1) The Section

Section 65(2)(e) includes in assessable income:

All profits or gains derived from the sale or other disposition of any personal property or any interest therein (not being property or any interest therein which consists of land within the meaning of section 67 of this Act), if the business of the taxpayer comprises dealing in such property, or if the property was acquired for the purpose of selling or otherwise disposing of it, and all profits or gains derived from the carrying on or carrying out of any undertaking or scheme entered into or devised for the purpose of making a profit: (emphasis added)

(a) The section comprises three limbs which are discussed below.

(b) The corresponding Australian provision is section 25A(1) (formerly section 26(a)) the Income Tax Assessment Act. To recapitulate section 25A(1) provides:

The assessable income of a taxpayer shall include profit arising from the sale by the taxpayer of any property acquired by him for the purpose of profit-making by sale, or from the carrying on or carrying out of any profit-making undertaking or scheme.

(c) Section 65(2)(e) uses the words "sale or other disposition". The provision is not therefore limited to profits or gains made from the sale of personal property. Other dispositions are also caught. Additionally the receipt of consideration other than of money could still give rise to an assessable profit or gain.

(d) The following comment was made by *Barwick C.J.* in *Investment and Merchant Finance Corp. Ltd. v. F.C. of T.*<sup>1</sup> in respect of the predecessor to the current Australian section: "Section 26(a) is intended in my opinion to deal with transactions which are entire in themselves and do not form part of a more extensive business." A lease transaction could constitute a transaction which was entire in itself.

### (2) The First Limb - The Business of Dealing in the Property

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<sup>1</sup>71 A.T.C. 4140 at p. 4142.

(a) Background *C.C.H. New Zealand Income Tax Law & Practice* states:<sup>2</sup>

The first limb of sec. 65(2)(e) has the effect of taxing profits or gains from the sale of property which would have been trading stock if sold in the conduct of the taxpayer's business. In practice, any profit or gain assessable under this provision will almost invariably be assessed as a business profit under sec. 65(2)(a).

As section 65(2)(a) has already been covered, this subsection is only discussed briefly.

For a profit or gain to be assessable:

(i) As at the date of sale, the taxpayer must be a dealer in the type of property sold, and

(ii) the property must be sold as part of his or her business.

*Woodhouse J. in Raine v Police*<sup>3</sup> described a dealer as: "one who buys or sells some form of merchandise, or who trades in some commodity, and to carry on business as a dealer suggests the organisation of some dealing activity into a course of conduct, even if only for a short period in terms of time..."

In *Bates v. C. of I.R.*<sup>4</sup> *Henry J.* observed that a person may be engaged in more than one business at a time. In respect of dealing he said it connoted:

...buying and selling or exchanging [property]. To constitute a business of dealing where a person does not hold himself out as carrying on such business, generally speaking, the law requires a reasonable frequency of transactions or some continuity of effort in respect of the buying, selling or exchanging of [property]. Even where there are a number of transactions concerning [property], they may well have some other explanation...They may constitute a form of investment or change of investment with the object of getting a return from the property in preference to other forms of investment of money. It is a question of fact or inference from fact in each case...Each case must be decided on its own facts.

A recent case which discusses section 65(2) (e) is *National Distributors Ltd. v. C. of I.R.*<sup>5</sup> The taxpayer was a property holding company. Most of its income was derived from rent. Cash surpluses were from time to time invested in shares of

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<sup>2</sup>*C.C.H. New Zealand Income Tax Law and Practice*, p. 11,031, 1993, C.C.H. New Zealand Limited.

<sup>3</sup>[1963] N.Z.L.R. 702.

<sup>4</sup>(1955) 11 A.T.D. 96 at p. 102.

<sup>5</sup>(1987) 9 N.Z.T.C. 6135.

public companies. The shares represented only a small portion of the total assets of the company. The Inland Revenue Department ruled that gains on the realisation of shares were assessable.

The High Court in that case held the taxpayer was not a dealer in shares because of the haphazard manner in which the shares were purchased and sold. The transactions were unsystematic and incidental to the company's main purpose of ownership of a property from which to derive rental income.

When property is sold by a dealer in that property, before the proceeds of sale will be assessable, the property must be sold as part of those dealing activities.<sup>6</sup> Accordingly property which was not acquired originally for the dealing activities but which is committed to those dealing activities by the time of its sale will give rise to an assessable profit or loss. Conversely property originally acquired as part of the dealing activities that is withdrawn from those activities prior to its sale will not give rise to an assessable profit or gain.

(b) Lease Incentives and the First Limb. Does the first limb have application to the receipt of a lease incentive?

In applying the first limb we need to focus on the lease transaction including the provision of the incentive, not the overall business activities of the lessee, to see whether the recipient is in business as a dealer.

To reiterate *Henry J.* in *Bates v. C. of I.R.*:<sup>7</sup> "A person may engage in more than one business at the same time, and the Court is concerned only with the question of whether or not at any material time the appellant was engaged in the business of dealing in [that property]". (emphasis added) In this case the question is whether the recipient of a lease incentive is a dealer in leases?

Turning to the principles outlined in determining whether a person is a dealer:

(i) there must be "a reasonable frequency of transactions or some

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<sup>6</sup>*Hazeldine v. C. of I.R.* (1968) N.Z.L.R. 747.

<sup>7</sup>(1955) 11 A.T.D 96 at p. 102.

continuity of effort in respect of the buying, selling or exchanging of [property]."<sup>8</sup>

In most occasions lessees move infrequently. It is unclear what *Henry J.* meant by "some continuity of effort". In respect of a single lease arrangement much continuous effort may be expended by the parties in negotiating the lease. If this is what *Henry J.* meant in *Bates* then the lessee receiving an incentive may be a dealer in leases. However it would appear he means where a number of similar transactions are made, in which case a single lease transaction will not meet this criteria.

(ii) Even where there are a number of transactions there may be another explanation: *Bates v. C. of I.R.* If there are a number of lease transactions over a period of time this may indicate for example, the expansion of the business of the taxpayer and a consequent need for more space.

(iii) As with most areas of law, each case is decided on its facts.

(iv) The test for dealing is applied at the time the property is disposed of: *R.O. Slake v. C. of I.R.*<sup>9</sup> Most lessees will not be in the business of dealing in leases at any stage of their tenancy.

Generally therefore a lessee will not be a dealer and any lease agreement and associated incentive will be incidental to the main purpose (business) of the lessee: *National Distributors Ltd. v. C. of I.R.*<sup>10</sup>

Where there is "a reasonable frequency of transactions or some continuity of effort" and no other explanation, a lessee may be in the business of dealing in leases. This conclusion ties in with the statement of *Richardson J.* in *C. of I.R. v. McKenzies N.Z. Ltd.*:<sup>11</sup> "A lease will be held on revenue account if the taxpayer trades in leases so that the leases form part of its trading stock or are otherwise regarded as circulating capital."

However in *McKenzies'* case as in most cases: "...the lease was part of the

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<sup>8</sup>*Ibid.*, p. 102.

<sup>9</sup>(1970) 1 A.T.R. 696.

<sup>10</sup>(1987) 9 N.Z.T.C. 6,135.

<sup>11</sup>(1988) 10 N.Z.T.C. 5233 at p. 5237.

profit-making structure of the business."

(3) The Second Limb - Property Acquired for the Purpose of Resale

The second limb of section 65(2)(e) includes in assessable income "All profits or gains derived from the sale or other disposition of any personal property... if the property was acquired for the purpose of selling or otherwise disposing of it..."

The emphasis is on the purpose of the taxpayer at the date the property is purchased. This limb therefore differs from the first limb in which the focus is on the date the property is sold.

(a) Principles in Respect of the Second Limb.

(i) 'Acquired'. No particular method of acquisition of the property is required by the section. However positive steps must have been taken by the taxpayer to acquire the property. The second limb does not apply to passive acquisitions such as inheritances and gifts: *A.G. Healing and Co. Ltd. v. C. of I.R.*<sup>12</sup>

(ii) Time of Acquisition. Property or an interest in property is acquired by the taxpayer at the time a binding contract to purchase is entered into: *Beetham v. C. of I.R.*<sup>13</sup> In addition "...if an interest in property such as a lease or an option is itself sold at a profit the time of acquisition is the date when that interest was acquired."<sup>14</sup>

(iii) There must be an Identity of Interests. It is not necessary that the physical condition of the property that is sold corresponds with the condition of the property at the date of acquisition. However the estate or interest of the taxpayer in the property sold must equate with the estate or interest acquired by the taxpayer, see for example *McClelland v. F.C. of T.*<sup>15</sup>

In *McClelland v. F.C. of T.* a one-half undivided share in land was inherited by the taxpayer. The taxpayer subsequently purchased her brother's share and

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<sup>12</sup>[1964] N.Z.L.R 222.

<sup>13</sup>72 A.T.C. 6042.

<sup>14</sup>*C.C.H. New Zealand Income Tax Law and Practice*, 1993 C.C.H. New Zealand Limited, p. 11, 101.

<sup>15</sup>70 A.T.C. 4115.

proceeded to subdivide and sell the land. It was held by *Windeyer J.* that the sale of the whole property was not the same property as the two interests acquired by her, one with the purpose of resale, the other without any purpose, being a devise under a will. Accordingly the Australian section did not apply.

(iv) The Purpose of Sale. The second limb revolves around the property in question being acquired for the purpose of sale or disposition.

(b) The Second Limb and *C. of I.R. v. National Distributors Ltd.*<sup>16</sup> As discussed under the first limb, this case concerned a property holding company that periodically invested cash surpluses in company shares. The Commissioner ruled the gains on realisations of shares were assessable. The Court of Appeal allowed the Commissioner's appeal. The majority (*Doogue J.* dissenting) found that the dominant purpose of the taxpayer company was to achieve a profit on the resale of the shares.

In reviewing the cases on section 65(2)(e) *Richardson J.* made a number of points including:<sup>17</sup>

(i) The test of the taxpayer's purpose is subjective requiring consideration of the taxpayer's state of mind at the time the property is acquired.

(ii) Where there is more than one purpose, the test is whether the dominant purpose of the taxpayer was one of sale or other disposition.

(iii) Motive, purpose and intention are distinguishable.

(iv) The nature of the asset that is purchased and the period of time it is held are important considerations.

(v) If purpose of the taxpayer is to sell in the future at a price which, when inflation is allowed for, is equal to or better than the price at the date of purchase, then that purpose is to sell that property even though the motive was to protect savings from inflation.

(vi) The fact that the taxpayer did not expect to retain the property forever and actually contemplated the possibility of its sale does not satisfy the test for the

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<sup>16</sup>(1989) 11 N.Z.T.C. 6346.

<sup>17</sup>*C.C.H. New Zealand Income Tax Law and Practice*, 1993 C.C.H. New Zealand Limited, p. 11, 104.

purposes of the second limb.

(vii) A taxpayer purchasing assets with only a general expectation that a financial benefit will be achieved in some undefined way will satisfy the onus of proving that there was no purpose of sale.

The application of the second limb in any case will finally come down to the facts of the particular case. The onus of proof is on the taxpayer to show that the property in question was not acquired for the purpose of sale or disposal. *Richardson J.* commented:<sup>18</sup>

Where subjective purposes are in issue the statements of the taxpayer, or of someone who can speak for the taxpayer, are obviously important evidence. But for obvious reasons they must be assessed and tested in the totality of circumstances which will include the nature of the asset, the vocation of the taxpayer, the circumstances of the purchase, the number of similar transactions, the length of time the property was held and the circumstances of the use and disposal of the asset. Actions may speak louder than words and the totality of circumstances may negate the asserted purpose of the purchase.

(c) Dominant Purpose. As stated by *Richardson J.* in the *National Distributors* case, the second limb only applies where the sole purpose or the dominant purpose of the taxpayer is the sale or other disposition of the property in question. The test was established in New Zealand *C. of I.R. v. Walker*<sup>19</sup> on the basis of corresponding Australian authorities and was approved by the Privy Council in *Holden v. C. of I.R.*<sup>20</sup> In respect of a taxpayer company, the purpose of the company is the purpose of those who are in control. Not a great deal of importance should be attached to the company's memorandum or articles of association.

(d) Purpose of the Taxpayer versus the Intention. In terms of the second limb there is a clear distinction between intention and purpose.

This is clearly illustrated by *Plimmer v. C. of I.R.*<sup>21</sup> The taxpayer was one of group who wanted to purchase all of the ordinary shares in a company in order to

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<sup>18</sup>(1989) 11 N.Z.T.C. 6346.

<sup>19</sup>[1963] N.Z.L.R. 339.

<sup>20</sup>(1974) 1 N.Z.T.C. 61,146.

<sup>21</sup>(1957) 11 A.T.D. 480.



gain control of the company. There were also preference shares on issue but the purchasers were not interested in buying those. The holder of the ordinary shares would not however sell except the group agree to purchase all the preference shares of the company on issue. Accordingly in order to obtain the ordinary shares, the group reluctantly purchased the preference shares. To finance the purchase of the preference shares, temporary bank accommodation was obtained on the understanding that the preference shares would be sold after the next balance sheet had been prepared. The preference shares were subsequently sold at a profit. The Commissioner assessed the taxpayer on his share of the profit relying on the predecessor to the second limb of section 65(2)(e).

*Barrowclough* C.J. found the Commissioner's assessment erroneous. He stated:<sup>22</sup>

[I]n the present case, I feel very confidently that the preference shares, though acquired with the intention of selling them, were not acquired for that purpose. The sale of the shares was not the object which the appellant and his friends had in mind. They did not buy them for the purpose or with the object of selling them; but solely because they could not acquire the ordinary shares unless they undertook contemporaneously to acquire the preference shares.

In the course of his judgment he also stated:

A man's purpose is usually, and more naturally, understood as the object which he has in view or selling without having also an intention of selling, but, in ordinary language, 'purpose' connotes something added to 'intention', and the two words are not usually regarded as synonymous. Though 'purpose' may sometimes mean 'intention', the court should hesitate to adopt that more restricted meaning unless the statute clearly evidences such an intention.

(e) Calculation of Profit. It appears from the majority of the Privy Council in *McClelland v. F.C. of T.*<sup>23</sup> that a profit that arises under the second limb of section 65(2)(e) must have been realised.

The amount of any profit or gain that is assessable under the second limb is a question of fact to be calculated according to ordinary commercial principles. This basically involves subtracting from the total sale price the original cost, capital improvements and expenditure involved in acquiring and selling the property.

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<sup>22</sup>*Ibid.*, p. 484.

<sup>23</sup>70 A.T.C. 4115 at p. 4119.

Obvious problems can arise, for example, where only part of the property that was acquired is sold.<sup>24</sup>

In respect of a lease incentive, if it were assessable under this limb, would the profit be calculated after deducting costs of moving and fit-out? If these were deducted from an incentive there may be a loss.

(f) Conclusion. Could the second limb of section 65(2)(e) apply to bring to tax a lease incentive?

At the time the property (the lease) is acquired (or entered into) there must be a purpose of selling or otherwise disposing of that property. Where there is more than one purpose, the section will apply if the dominant purpose of the taxpayer is the sale or disposition of that property.

(i) Sold or Otherwise Disposed Of. In entering a lease, a lessee acquires a right to occupy premises for an agreed period and rental set out in the lease agreement. The right entitles the lessee to use the premises and operate its business from them. In most cases the right to lease expires and is not sold or otherwise disposed of. In some cases, however, part way through the tenancy the lessee may sub-let or assign the right to the premises. In such a case the rental derived by the lessee from the sub-lease would be assessable to the lessee as business income, or income according to ordinary concepts as a matter of course and not under this limb.

Alternatively a lessee may exit the lease part way through its term. Generally in this case there will be a cash outflow not inflow by way of a termination or surrender payment made by the lessee, in which case the issue will be one of the deductibility of the payment.

Occasionally a lessor may make a payment to the lessee to terminate the lease. In such a case it is unlikely that the second limb would apply to the recipient of the payment as generally the lease would not have been entered by the lessee with this purpose in mind.

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<sup>24</sup>*Bedford Investments Ltd. v. C. of I.R.* [1953] N.Z.L.R. 978.

(ii) Sole or Dominant Purpose. It is unlikely that the sole or dominant purpose of the lessee when negotiating a lease of premises is to sell or otherwise dispose of the lease. The sole or dominant purpose in entering the lease in most cases will be to obtain premises from which to carry on a business. In addition, when a lease incentive is received it will be received on entering the lease not on its sale or disposition.

Accordingly in most leasing arrangements the second limb will not apply because (i) the sole or dominant purpose of the lessee entering a lease will not be to sell or dispose of the lease but to obtain premises from which to carry on its business and (ii) generally a lease will expire after a specified pre-determined period rather than being disposed of or sold.

The limb may apply to more complex leasing arrangements. An example may be where the lessor gives the fit-out to the lessee and the lessee grants an option to the lessor to purchase the fittings when the lease expires, at a price to be negotiated at that time. In this case, the subsection may apply when the fittings are subsequently sold back to the lessor. This is subject of course to the lessee's purpose when the property was acquired.

#### (4) The Third Limb - Profit-making Schemes or Undertakings

The third limb of section 65(2)(e) includes in assessable income: "...all profits or gains derived from the carrying on or carrying out of any undertaking or scheme entered into or devised for the purpose of making a profit:".

The cases on this provision, and its predecessor bring out a number of principles.

(a) Profits Derived must be of an Income Character. For a profit to be assessable under the third limb the undertaking or scheme must produce a gain of an income nature not of a capital nature.<sup>25</sup>

The Privy Council decision in *McClelland v. F.C. of T.* stated to come within the Australian equivalent of the third limb, the taxpayer's activity must exhibit

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<sup>25</sup>*Eunson v C. of I.R.* [1963] N.Z.L.R. 278 at p. 280. *Beetham v C. of I.R.* 72 A.T.C. 6042 at p. 6052.

features which bear the characteristics of a business endeavour. This view does not appear to represent the New Zealand position. In New Zealand an undertaking or scheme can give rise to an assessable profit even though the undertaking or scheme does not amount to a business.

Consideration of whether profit is income will be determined by looking at the facts of the case and general principles of capital and income.

(b) Purpose of Profit-making. The tests to ascertain whether an undertaking or scheme has been entered into or devised for the purpose of making a profit are the same as those under the second limb to determine if property was acquired for the purpose of sale: *C. of I.R. v. Walker*. If there is more than one purpose, the dominant purpose test is applied.

The time at which the purpose of profit-making is to be determined is the time when the undertaking or scheme is entered into or devised for that purpose of making a profit, and not when the property used in the undertaking or scheme is acquired: *Gilmour v. C. of I.R.*<sup>26</sup>

The purpose of entering into a profit-making scheme or undertaking may exist at the time the property is acquired.<sup>27</sup> Property can be committed to a profit-making scheme after its acquisition. In *Bernard Elsey Pty. Ltd. v. F.C. of T.*<sup>28</sup> land was purchased by the taxpayer for investment purposes. Eventually however the taxpayer built shops for sale at a profit. The profit was assessable under the equivalent Australian section.

Finally where one undertaking or scheme happens to lapse and is replaced by a new undertaking or scheme, for the purposes of the third limb the relevant time is when the latter undertaking or scheme was devised or entered into: *Steinberg v. F.C. of T.*<sup>29</sup> per Stephen J.

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<sup>26</sup>[1968] N.Z.L.R. 136.

<sup>27</sup>For example *Bedford Investments Ltd. v. C. of I.R.* [1953] N.Z.L.R. 978.

<sup>28</sup>69 A.T.C. 4126.

<sup>29</sup>75 A.T.C. 4221.

There are a number of Australian decisions on the equivalent Australian section including *F.C. of T. v. The Myer Emporium Ltd.*,<sup>30</sup> *Henry Jones (IXL) Ltd. v. F.C. of T.*,<sup>31</sup> and *Westfield v. F.C. of T.*<sup>32</sup>

(c) Uncompleted Schemes or Undertakings. A person who acquires property that is the subject of an uncompleted scheme or undertaking will for the purposes of the third limb be assessed only if he or she continues with the scheme or undertaking and carries it on in his or her own right: *Official Receiver in Bankruptcy (Trustee, Estate of William Fox, known as Rankin, deceased) v. F.C. of T.*<sup>33</sup> and *Rhodesia Metals (in liq.) v. C. of T.*<sup>34</sup>

Conversely a person who abandons a scheme before its completion may not be assessable under this limb: *Kratzmann v. F.C. of T.*<sup>35</sup> In that case the taxpayer purchased a block of land with the purpose of putting up a building and selling sufficient units in the building to cover the project's cost. The project was abandoned for financial reasons. The property was sold at a profit. The sale was not assessable under the Australian equivalent of the third limb as it arose after the abandonment of the scheme.

(d) The Words 'Undertaking' and 'Scheme'. These words are defined according to everyday usage. The words refer to an enterprise or plan of action.

*C.C.H. Income Tax Law and Practice*<sup>36</sup> cites statements from three cases that discuss the meaning of these words:

"An undertaking in that sense implies some engagement or the like with

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<sup>30</sup>87 A.T.C. 4363.

<sup>31</sup>91 A.T.C. 4663.

<sup>32</sup>91 A.T.C. 4234.

<sup>33</sup>(1956) 96 C.L.R. 370.

<sup>34</sup>[1940] A.C. 774.

<sup>35</sup>70 A.T.C. 4043.

<sup>36</sup>*C.C.H. New Zealand Income Tax Law and Practice*, 1993 C.C.H. New Zealand Limited, p. 11, 302.

some other person or persons": *Eunson v. C. of I.R.* per Henry J.<sup>37</sup>

"...an undertaking or scheme must involve a programme or plan of action;...it presupposes...activities which are co-ordinated by plan and purpose.": *Steinberg v. F.C. of T.* per Stephen J.<sup>38</sup>

"...doubtless it connotes a plan or purpose which is coherent and has some unity of conception": *Australian Consolidated Press Ltd. v. Australian Newsprint Mills Holdings Ltd.*<sup>39</sup>

Henry J. in *Vuleta v. C. of I.R.*<sup>40</sup> referred to the *Shorter Oxford Dictionary* definition of 'scheme' in the sense used in section 88(1)(c) as, "a plan, design or programme of action, hence a plan of action devised in order to attain some end, a project, an enterprise".

(e) Calculation of Profits or Gains. To calculate the profit or gain derived under this limb, the property utilised for the purposes of the profit-making undertaking or scheme is brought into account at its value at the time that the undertaking or scheme commenced and in its existing form at that time. It is not therefore brought in at its original cost, unless of course the undertaking or scheme is commenced on acquisition.

In addition the costs and outgoings incurred in carrying out the undertaking or scheme can be set against the receipt or receipts earned: *Bernard Elsey v. F.C. of T.*

(f) The Sale of a Capital Asset. The realisation of a capital asset will not amount to a profit-making undertaking or scheme merely because it is realised in the most advantageous manner. For example, in *Eunson v. C. of I.R.*, Henry J. held that the owner of farm land who sells land surplus to his requirements by subdividing the land does not carry on or carry out a scheme under the third limb.

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<sup>37</sup>[1963] N.Z.L.R. 278 at p. 280.

<sup>38</sup>75 A.T.C. 4221 at p. 4242.

<sup>39</sup>(1960) 105 C.L.R. 473 at p. 479.

<sup>40</sup>[1962] N.Z.L.R. 325 at p. 329.

In *Beetham v. C. of I.R.*, a dairy farmer subdivided his dairy farm when it became uneconomical for him to continue as a town supplier. The taxpayer purchased a more suitable property. It was held by *Henry J* that the subdivision was simply the realisation of an asset to the best advantage and not an undertaking or scheme.

These decisions indicate that the New Zealand courts have accepted and followed the majority of the Privy Council in *McClelland v. F.C. of T.* The Australian courts have however taken the view that not all of that case represents good law, in respect of Australia at least. To this end see, for example, *F.C. of T. v. Whitfords Beach Pty. Ltd.*<sup>41</sup>

(g) Conclusion. Where the lessee enters into an agreement to lease premises and receives an incentive as consideration for doing so, will the incentive be assessable under the third limb?

(i) Is there an Undertaking or Scheme? As stated earlier the courts refer to the meanings of these words as defined in everyday usage. It involves "a plan, design or programme of action, hence a plan of action devised in order to attain some end; a project, an enterprise".<sup>42</sup>

It is difficult to envisage a lease agreement and incentive being so categorised. In everyday usage the word 'scheme' refers most commonly to the subdivision of land, a subdivision 'scheme'. Such ventures involve a number of steps, a "plan of action" to produce the profit or gain which is assessed. In respect of the leasing of premises while there are negotiations prior to any agreement being formally signed there is no "plan, design or programme of action...a plan of action devised in order to attain some end; a project, an enterprise".

(ii) The time when the purpose of making a profit must be determined is the time when the scheme or undertaking is entered into or devised for that purpose. Where there is more than one purpose the third limb will only apply

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<sup>41</sup>82 A.T.C. 4031.

<sup>42</sup>*Vuleta v. C. of I.R.* [1962] N.Z.L.R. 325 at p. 329.

where the dominant purpose was to derive a profit from carrying on or carrying out any undertaking or scheme.

As concluded in the discussion of the second limb generally the sole or dominant purpose of a taxpayer entering into a lease of premises will be to obtain premises from which to carry on its business. It will not be to derive a profit from an undertaking or scheme.

Accordingly I believe in most cases the third limb will not apply to the leasing of premises and provision of a lease incentive. It is unlikely that a lease transaction will constitute an undertaking or scheme and generally the sole or dominant purpose of a lessee entering a lease will not be to derive a profit but to carry on its business.

If the lease transaction were a profit-making undertaking or scheme, there may be no profit derived anyway. The profit under the third limb is calculated by deducting costs and outgoings incurred in carrying out the undertaking or scheme. In the case of a lease transaction and a cash incentive, the costs of moving premises and fitting out the new premises could well exceed the incentive payment, in which case there would be a loss not a profit.

It therefore appears section 65(2)(e) will not apply to the provision of a lease incentive.



### 3. SECTION 65(2)(1)

Section 65(2)(1) is a "catch-all" provision, including within the term assessable income "Income derived from any other source whatsoever." The subsection brings within assessable income any receipts that are in the nature of income according to ordinary concepts and are not treated as assessable by any other provision in the Act. The equivalent section in Australia is section 25(1) which as already mentioned includes in the assessable income of Australian resident taxpayers "the gross income derived directly or indirectly from all sources whether in or out of Australia" and for non-residents "the gross income derived...from all sources in Australia".

#### (1) Case Examples

*C.C.H. Income Tax Law and Practice*<sup>1</sup> gives a number of examples of the application of the section. Three of these examples are briefly detailed below.

(a) *Louisson v. C. of T.*<sup>2</sup> A payment made by a serviceman's former employer to supplement his military pay was not assessable as income derived from any other source whatsoever. To be assessable income the payment must be in the nature of an income receipt. In this case the payment was in the nature of a personal gift or tribute or a present. *Fair J.* in his judgment commented: "[sec. 65(2)(1)] has been held in *Tillard v. C. of T.* to be a paragraph which is supplementary to the others, and may include income which is not included under them".

(b) *Beazley v. C. of I.R.*<sup>3</sup> The case involved four taxpayers who combined their resources to purchase, at a discount, commercial bills. *Casey J.* held that the profits that arose on maturity of the bills were assessable as business profits and as a result of an undertaking or a scheme. He also held that the profits derived were assessable as income from any other source. In this regard he defined the issue to be

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<sup>1</sup>*C.C.H. New Zealand Income Tax Law and Practice*, 1993 C.C.H. New Zealand Ltd. p. 2592.

<sup>2</sup>[1942] N.Z.L.R. 30.

<sup>3</sup>(1980) 4 N.Z.T.C. 61, 527.

"whether commercial men would regard the discounted sum as income in the ordinary sense of the word". His Honour thought that commercial men clearly would regard the discounted sum as income.

(c) *Reid v. C. of I.R.*<sup>4</sup> This case which is discussed in other parts of the thesis, concerned a student teacher allowance that was paid to a trainee primary school teacher. As a condition of the allowance, the taxpayer entered into a bond undertaking to refund all or part of the bond if he did not complete the prescribed course and three years' post graduation teaching. He filed a return of income claiming a refund of the PAYE tax deductions made from the allowance.

*Richardson J.* in deciding that the amounts received pursuant to the allowance were income according to ordinary concepts commented that:<sup>5</sup>

The sums in question were regular periodical payments made to the appellant to defray his expenses while attending teachers' college full time as a teacher trainee. They were paid to him for that purpose and were the whole or part of the receipts upon which he depended for that purpose. They were not gifts. They were contractual payments to which the appellant was entitled so long as he performed his part of the bargain. They were emoluments received in respect of and in return for his performance of the obligations of his studentship he had undertaken.

Earlier he stated:<sup>6</sup>

To come within the residual paragraph of sec 65(2) the payments received must be income according to ordinary concepts and be derived from a source not otherwise covered in the earlier paragraphs of the subsection.

*Richardson J.* went on to find the payments were exempt under section 61(37).

## (2) Distinguishing between Income and Capital

Whether a receipt such as a lease incentive is income under section 65(2)(1) is to be determined in accordance with the ordinary concepts and usages of mankind. The criteria for characterising receipts, covered in the first section of this thesis are relevant to this discussion. Of those three criteria the one most applicable to the

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<sup>4</sup>(1985) 7 N.Z.T.C. 5 176.

<sup>5</sup>*Ibid.*, p. 5183.

<sup>6</sup>*Ibid.*, p. 5182.

treatment of an incentive under this subsection is that concerning the quality of the receipt in the hands of the recipient.

The current approach to distinguishing between capital and income in New Zealand is found in *C. of I.R. v. McKenzies N.Z. Ltd.*<sup>7</sup> which as already discussed concerned a lump sum payment made by the lessee to the lessor in consideration for the surrender of a lease.

In the Court of Appeal *Richardson J.* stated the lease was part of the profit-making structure of the business and therefore capital. The only exception to this would be where the taxpayer traded in leases, in which case the leases would form part of the taxpayer's trading stock or be regarded as circulating capital. And: "...in an uncomplicated case the characterisation of the asset acquired or disposed of will determine the character or quality to be attributed to the costs of acquisition or disposal, as the case may be."<sup>8</sup> (emphasis added) As the lease was a capital item, the lump sum payment made to surrender the lease was therefore regarded as capital expenditure.

Applying the criteria of the quality of the receipt in the recipients' hands to a lease incentive, most lessees will not trade in leases. The lease of premises will secure a place from which the lessee can carry on its business. As such the lease will form part of the taxpayer's business structure and will be a capital asset of the lessee. Most lease transactions will be "an uncomplicated case". Accordingly the incentive will take its character from the asset. The lease is a capital asset therefore so will be the incentive.

One of the tests referred to by the Privy Council in *B.P. Australia Ltd. v. Commr. of Taxation of the Commonwealth of Australia*<sup>9</sup> was whether the payments were made in respect of the taxpayer's business structure or were part of the income earning process. This test was mentioned by *Richardson J.* in *McKenzies*.

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<sup>7</sup>(1988) 10 N.Z.T.C. 5233.

<sup>8</sup>*Ibid.*, 5237.

<sup>9</sup>[1966] A.C. 224.

As already discussed, the Australian cases of *F.C. of T. v. The Myer Emporium Ltd.*<sup>10</sup> and *F.C. of T. v. Cooling*<sup>11</sup> in determining whether a receipt is income or capital, have moved from distinguishing between the profit-making structure and income earning process to distinguishing between transactions "in the course of business activity" and those that are not.

At this stage the approach adopted in *Myer* and *Cooling* has not been followed in New Zealand. *McKenzies'* case was decided in 1988 and after the *Myer* case. It however concerned the issue of the deductibility of a payment not the assessability of a receipt. It did not refer to *Myer*.

In the recent Court of Appeal decisions of *C. of I.R. v. Thomas Borthwick and Sons (Australasia) Ltd.*<sup>12</sup> and *C. of I.R. v. Inglis*<sup>13</sup> both decided after *Cooling*, reference was made to passages in the *B.P. Australia* case. No reference was made to either *Myer* or *Cooling*.

### (3) Conclusion

(a) This subsection revolves around whether a receipt is income according to ordinary concepts. Case law principles are the starting point in applying this provision to a particular receipt.

(b) In respect of lease incentives, in New Zealand there are no decided cases on lease incentives. There is however *McKenzies* on the antithesis, a lease termination payment.

(c) *Richardson J.* in *McKenzies'* case said (generally,) a lease is a capital asset being part of the profit-making structure of the business. In an uncomplicated case the characterisation of the asset that is acquired or disposed of, will determine the character or quality to be attributed to the costs of acquisition or disposal whichever is the case. On this basis a lease incentive will be a capital asset in the

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<sup>10</sup>87 A.T.C. 4363.

<sup>11</sup>90 A.T.C. 4472.

<sup>12</sup>(1992) 14 N.Z.T.C. 9101.

<sup>13</sup>(1992) 14 N.Z.T.C. 9180.

recipient's hands, because the lease it relates to is a capital asset.

(d) In *Beazley v. C. of I.R.*, in respect of this subsection and the assessability of profits from the maturity of commercial bills, *Casey J.* stated the issue to be "whether commercial men would regard the discounted sum as income in the ordinary sense of the word." In the case of a lease incentive, commercial people would be likely to regard the receipt as a capital gain.

(e) In Australia the *Myer* and *Cooling* decisions have departed from the distinction between the profit-making structure and transactions in the course of its operations. These cases distinguished between transactions "in the course of business activity" and other transactions. If the approach in these cases were applied to a lease incentive in New Zealand, it is extremely likely the incentive would be income according to ordinary concepts.

(f) To date there has been no application of the principles outlined in *Myer* and *Cooling* in New Zealand.

## CHAPTER II

### THE AUSTRALIAN TAXATION RULING

#### INTRODUCTION

In 1991, as a result of the *Cooling* case,<sup>1</sup> the Commissioner issued an income tax ruling IT2631 concerning the provision of lease incentives.<sup>2</sup> The ruling deals briefly with cash incentives, its focus being on non-cash incentives. It discusses both the assessability and deductibility of lease incentives.

I shall review the ruling with a view to identifying principles in it that may apply to the New Zealand situation. As noted earlier the New Zealand Inland Revenue are currently looking at the taxation implications of lease incentives. The position of the Australian Commissioner may be used as a guide by the New Zealand Revenue in setting its policy. In addition there is legislation in Australia in respect of the convertibility of non-cash benefits for which we have no equivalent here. At some time when the issue of lease incentives is looked at in New Zealand, Parliament may enact similar legislation here.

Before the ruling was published an article was written by Still and Neilson<sup>3</sup> concerning the taxation of lease incentives. Where applicable that article and the ruling are compared and contrasted.

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<sup>1</sup>*F.C. of T. v. Cooling* 90 A.T.C. 4472.

<sup>2</sup>*IT2631 Income Tax: Lease Incentives*, Supplement to (1991) 25 Taxation in Australia, No. 11, R 45.

<sup>3</sup>Still and Neilson, *Taxation Implications of Lease Incentives*, The C.C.H. Journal of Australian Taxation: December 1990/January 1991, p. 4.

# 1. THE ASSESSABILITY OF AN INCENTIVE

## (1) Introduction

The ruling recognises that incentives take many forms from lump sum upfront payments to non-cash incentives such as free fit outs and holiday packages.

In relation to all incentives whether in cash or not, the ruling states "the question must be asked, does the benefit have an income character?"

The ruling begins its analysis by quoting a passage from the decision of the High Court in *F.C. of T. v. The Myer Emporium Ltd.*<sup>1</sup> which was quoted by Hill J. in *Cooling*:

A receipt may constitute income, if it arises from an isolated business operation or commercial transaction entered into otherwise than in the ordinary course of the carrying on of the taxpayer's business, so long as the taxpayer entered into the transaction with the intention or purpose of making a relevant profit or gain from the transaction.

The ruling cites three further passages from Hill J.'s judgment in *Cooling*. Specifically,<sup>2</sup>

Where a taxpayer operates from leased premises, the move from one premises to another and the leasing of the premises occupied are acts of the taxpayer in the course of its business activity just as much as the trading activities that give rise more directly to the taxpayer's assessable income. Once this is accepted, the evidence established that in Queensland in 1985 it was an ordinary incident of leasing premises in a new city building, at least where the premises occupied were of substantial size, to receive incentive payments of the kind in question. Why then should a profit received during the course of business where the making of such a profit was an ordinary incident or part of the business activity of the firm not be seen to be income in ordinary concepts?

And in respect of whether the transaction which gave rise to the cash incentive could be characterised as a profit-making scheme.<sup>3</sup>

A scheme may be a profit-making scheme notwithstanding that neither the sole nor the dominant purpose of entering into it was the making of the profit.

He summarised his position as:<sup>4</sup>

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<sup>1</sup>87 A.T.C. 4363 at p. 4367.

<sup>2</sup>90 A.T.C. 4472 at p. 4484.

<sup>3</sup>*Ibid.*, p. 4484.

<sup>4</sup>*Ibid.*, p. 4484.

In my view the transaction entered into by the firm was a commercial transaction; it formed part of the business activity of the firm and a not insignificant purpose of it was the obtaining of a commercial profit by way of the incentive payment.

*Hill J.* accordingly decided the payment was income according to ordinary concepts.

(2) General Statement:

(a) Cash Payments. On the basis of the *Myer* and *Cooling* decisions the ruling states: "where a business taxpayer is given a cash incentive to enter into a lease of business premises, the incentive is income of the taxpayer".<sup>5</sup>

This position applies also to:

- (i) amounts paid in consideration of the variation of a lease to rent extra space;
- (ii) amounts paid to relocate in the same building; and
- (iii) an incentive paid to encourage an existing tenant to remain in the let premises.

(b) Non-Cash Payments. Where a business taxpayer receives a non-cash incentive to enter a lease of business premises or to vary such a lease, the incentive will have an income character so long as it is convertible into cash, either as a matter of fact or through the operation of section 21A of the Australian Income Tax Assessment Act.

(c) Incentives to New Businesses. The ruling concedes an incentive paid to a taxpayer entering into a lease to commence an entirely new business will not be income. "On balance, it is considered that the decisions in *Myer* and *Cooling* could not be interpreted to treat a one-off payment of this kind to a new business taxpayer as income".<sup>6</sup> This concession is made under the heading "Non-cash payments", however presumably it applies to cash and non-cash payments alike.

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<sup>5</sup>*IT 2631 Income Tax: Lease Incentives*, Supplement to (1991) 25 Taxation in Australia, No. 11, R45.

<sup>6</sup>*Ibid.*, R46.



The payment, according to the ruling will however constitute an assessable capital gain by virtue of the capital gains provisions.

(3) Non-Cash Benefits - convertible into cash

The issue of the convertibility of a non-cash benefit has been considered in a number of cases. The ruling gives several examples, specifically:

(a) Tennant v Smith.<sup>7</sup> An employee, a bank agent, was bound as part of his duty to occupy the bank house. He was not entitled to sublet the bank house or use it for any other business except that of the bank. The House of Lords held that the benefit was not income because it could not be turned to pecuniary account and therefore it did not represent money or money's worth. The ruling quotes the following extracts from the case:

Lord *Halsbury* L.C. said:

I come to the conclusion that the Act refers to money payments made to the person who receives them, though, of course, I do not deny that if substantial things of money value were capable of being turned into money they might for that purpose represent money's worth and be therefore taxable.

Lord *Watson* held that:

...profits in its ordinary acceptation, appears to me to denote something acquired which the acquirer becomes possessed of and can dispose of to his advantage - in other words, money - or that which can be turned to pecuniary account.

Lord *Hannen* said:

That which could be converted into money might reasonably be regarded as money - but that is not the case before us.

(b) F.C. of T. v. Cooke & Sherden.<sup>8</sup> The taxpayers carried on the business of home delivery retailers of soft drinks. They received free holidays from the drink manufacturer as a bonus for reaching specified sales quotas. The holidays were non-deferrable and could not be cashed in. The value of the free holidays was not income in the hands of the recipients.

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<sup>7</sup>(1892) A.C. 150.

<sup>8</sup>80 A.T.C. 4140.

The Full Federal Court in *Cooke & Sherden* quoted the three extracts from *Tennant v Smith* noted above and went on to conclude: "If a taxpayer receives a benefit which cannot be turned to pecuniary account, he has not received income as that term is understood according to ordinary concepts and usages".

The ruling notes that some non-cash benefits can be readily converted into cash such as a motor vehicle or boat. The ruling refers to two cases noted in *Cooke & Sherden* where non-cash benefits had been assessed.

In the first case, *Heaton v Bell*,<sup>9</sup> an employee was given the free hire of a motor vehicle. If he had surrendered the free hire of the vehicle, he would have become entitled to a higher monetary wage.

The second case, *Abbott v Philbin*,<sup>10</sup> concerned an option to purchase shares in the company at a certain price which was granted to a secretary of a company. The monetary value of the option was considered taxable because:

It was not incapable of being turned into money or of being turned to pecuniary account within the meaning of these phrases in *Tennant v Smith* ... merely because the option itself was not assignable. What the option did was to enable the holder at anytime, at his choice, to obtain shares from the company which would themselves be pieces of property or property rights of value, freely convertible into money.

(c) Section 21A. In relation to non-cash business benefits provided after 31 August 1988,

(i) Section 21A(1) of the Income Tax Assessment Act provides "...in determining the income derived by a taxpayer, a non-cash business benefit that is not convertible to cash shall be treated as if it were convertible to cash". The subsection counters the effects of cases such as *Cooke & Sherden*. Accordingly when deciding whether a non-cash business benefit provided after 31 August 1988 is assessable income, it is not relevant to argue that the benefit cannot be converted to cash.

(ii) Section 21A(2) requires that both "convertible" and "non-convertible" non-cash business benefits provided after 31 August 1988 which are income of a business taxpayer, be included in the taxpayer's assessable income at their arm's

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<sup>9</sup>(1970) A.C. 728.

<sup>10</sup>(1961) A.C. 352.

length value, less any amount that is paid as consideration for the benefit. In determining the arm's length value of a "non-convertible" business benefit, any conditions that would prevent or restrict the benefits conversion to cash shall be disregarded.

New Zealand does not have equivalent legislation overriding the effect of the case law.

(d) Otherwise deductible rule. The ruling refers to some non-cash lease incentives being revenue neutral, having no adverse tax consequences. This is the case if the taxpayer could have deducted the cost of the benefit if the taxpayer had incurred an expense in relation to the benefit.

The Treasurer issued a Press Release on 4 February 1985 on non-cash benefits. The ruling is consistent with the Treasurer's Press Release in which he said:<sup>11</sup>

In those situations where a benefit is used in a way such that its cost would have been fully tax deductible, the benefit will not be subject to tax. Where that cost would have been partly tax deductible, only the non-deductible part of its assessable value will be taxed. Where the benefit consists of an item of depreciable plant, depreciation will be allowed on the basis of its taxable value, but investment allowance will not be available if the plant would otherwise qualify.

Section 21A(3) puts this into effect:

[It] stipulates that where a non-cash business benefit is income of a taxpayer in a year of income, and, if the taxpayer had, at the time the benefit was provided, incurred and paid unreimbursed expenditure in respect of the benefit equal to the amount of the arm's length value of the benefit, a once-only deduction would have been allowable to the taxpayer in respect of a percentage of the expenditure, the assessable amount will be reduced by the deductible percentage. This is known as the 'otherwise deductible' rule.<sup>12</sup>

A once-only deduction is defined by subsection 21A(5) as, in the words of the ruling, "a deduction in a year of income in respect of a percentage of expenditure where no deduction is allowable in respect of a percentage of the expenditure in any other year of income."<sup>13</sup>

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<sup>11</sup>*IT 2631 Income Tax: Lease Incentives*, Supplement to (1991) 25 Taxation in Australia, No. 11, R47.

<sup>12</sup>*Ibid.*, R47.

<sup>13</sup>*Ibid.*, R47.

Accordingly revenue expenses, such as rent, which would be deductible in that year if they were incurred, would be taken into account in reducing the taxpayer's assessable income.

The definition of once-only deductions does not include depreciation allowances. Subsection 21A(3) will not therefore apply to reduce the taxable amount of a business benefit in the form of depreciable plant or articles. However, where a non-cash lease incentive is a new unit of property, within the meaning of subsection 54(2) of the Income Tax Assessment Act, the cost for the purposes of depreciation will be deemed to be the cost to the landlord.

Again in New Zealand there are no equivalent provisions in the Income Tax Act 1976.

The remainder of this section looks at the tax treatment of various forms of non-cash incentives.

#### (4) Rent Free Periods and Rent Discounts

The incentive may be that no rent is paid by the lessee in respect of the premises for an agreed period or, alternatively the lessee pays a reduced rent, i.e., a rent below the rate normally charged on an arm's length basis.

(a) The Ruling. In respect of rent-free periods the ruling states, if the lessee had paid rent for the premises or a higher level of rent for the premises, the lessee would be able to claim a deduction for the rent paid. The effect of the otherwise deductible rule in subsection 21A(3) would be to reduce the taxable amount of the benefit to nil. Effectively therefore a rent-free period is tax-free.

(b) New Zealand. As already stated, New Zealand does not have any equivalent of section 21A. There are however one or two provisions that may have limited application.

(i) Inadequate Rent. Section 98 of the Income Tax Act 1976 applies to the situation where a property is leased to a relative of the owner, or to a related company, for an inadequate rent or for no rent. It deems an adequate rent for the

property to be payable to the lessor and to be income of the lessor. The terms "relative" and "related company" are defined in the section.

Therefore where a building is leased and the lessor and lessee are related as defined, and a rent holiday or discount is provided, section 98 could apply. The Commissioner could deem an adequate rent be payable to the lessor for the property, the effect of which would be to increase the lessor's assessable income.

As most lease transactions are between arm's length parties however, this section will have limited application to rent holidays and discounts.

(ii) Deemed Dividend? A rent holiday or rent discount could be assessable in limited circumstances as a deemed dividend. The term "dividend" includes:

The making available, on or after the 1st day of October 1988, of any property of the company for the benefit of any shareholder of the company to the extent that the value of the benefit enjoyed by the shareholder exceeds the amount or value of any consideration provided to the company by the shareholder for provision of the benefit. (Per section 4 (1)(e) of the Income Tax Act 1976).

The provision could apply where a company which owns a building leases part thereof to a shareholder and charges a reduced or zero rent. In such a situation the difference between the consideration paid by the shareholder for the use of the premises, and the value (rent) of the premises is a deemed dividend assessable in the hands of the shareholder. In the case of a rent holiday, the deemed dividend will be equal to the rent that would have been charged normally for the lease of those premises.

The section has wider application in respect of proprietary companies by virtue of section 4(1)(l) which extends the application of section 4(1)(e) to cover the provision of property of the company to an associated person of a shareholder of the company or any trust under which the shareholder or the spouse of the shareholder is a beneficiary. Accordingly if premises were let at a discount for example, to a trust under which a shareholder in the company or a shareholder's spouse was a beneficiary, this would constitute a dividend.

As stated in respect of section 98, most lease agreements will be made between arm's length parties, therefore the dividend provisions will not apply to any rent discount or rent holiday provided to a lessee.

The taxation of dividends is a complex area and one which has seen a number of changes in recent years. I have not discussed the dividend provisions in any detail due to the limited application of them to the taxation of lease incentives.

(iii) Case Law. In New Zealand, as already mentioned, we have no equivalent of section 21A of the Income Tax Assessment Act. Accordingly, principles from the cases will play a role in determining whether such an incentive would be assessable.

Still and Neilson<sup>14</sup> comment that it may be argued for tax purposes that a rent holiday cannot be treated separately from the lessee's other rights and obligations under the lease. In return for rent payments and obligations under the lease, the lessee receives a right of occupancy for the entire period of the lease. It will arguably not receive any other benefit distinct from the right of occupancy. This may of course depend on the terms of the relevant lease and any other arrangements between the parties. If however, this is an appropriate description of the particular rent holiday being considered, it may be contrasted with the facts of *F.C. of T. v. Cooke & Sherden* and *Tennant v. Smith* discussed earlier.

Still & Neilson argue for the Commissioner to treat the rent holiday as constituting any form of profit or gain of an income nature:<sup>15</sup>

[The Commissioner] would seem to have to argue that, despite the fact that there is only one lease, the rent and other obligations of the tenancy are consideration only for the period other than the rent holiday, while the right of occupancy during the rent holiday is a separate benefit provided to the lessee for no consideration.

They also suggest if a court were to reach a conclusion that some form of receipt, profit or benefit was derived as a result of the rent holiday, Australian case law would suggest that receipt, profit or benefit would not be income unless

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<sup>14</sup>Still & Neilson, *Taxation Implications of Lease Incentives*, The C.C.H. Journal of Australian Taxation: December 1990/January 1991, p. 6.

<sup>15</sup>*Ibid.*, p. 6.

convertible to money or money's worth. Authority for the proposition again being found in *Cooke and Sherden* where the Full Federal Court of Australia stated that:<sup>16</sup>

If the receipt of an item saves a taxpayer from incurring expenditure, the saving is not income: *income is what comes in, it is not what is saved from going out*. A non-pecuniary receipt can be income if it can be converted into money; but if it be inconvertible, it does not become income merely because it saves expenditure. (emphasis added by Still & Neilson)

That case, and *Tennant v. Smith* the author's believe, appears to preclude the Commissioner from contending that the lessee derives an amount which is assessable income, merely because the lessee would have had to pay rent for those or other premises if there had not been the rent holiday. They note if the lessee were entitled to sub-let or assign its right of occupancy of the premises, the Commissioner on the basis of *Tennant v. Smith* could argue the rent holiday is income, being a benefit that is convertible into money. However, where the lease is so drawn that the lessee's rights of occupation of the premises cannot be sub-let or assigned, (at least during the rent holiday), the authors' submit the better view to be that the lessee will not derive an amount that is income according to ordinary concepts and usages as a result of the rent holiday.

(iv) Conclusion. The convertibility principle applies in New Zealand. Unless the rent benefit provided was convertible to money, for example, if the premises were available to be sub-let, it is unlikely that a rent-holiday or rent discount would be assessable to the recipient.

(5) Interest - Free Loans

(a) The Ruling. The Australian Tax Office ruling relates largely to the operation of section 21A, in particular subsection 21A(3). If the lessee had paid interest on the loan, the interest would have been deductible, assuming the loan funds were applied for the purpose of producing income. The application of the otherwise deductible rule in the subsection reduces to nil the taxable amount of the benefit.

However the ruling states:<sup>17</sup>

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<sup>16</sup>80 A.T.C. 4140 at p. 4149.

...available information suggests that consideration is being given to providing long-term interest free loans in lieu of cash incentives. In the circumstances, it would be necessary to establish that the true nature of the transaction was a loan rather than an arrangement for the avoidance of the tax to which Part IVA might apply.

(b) New Zealand

(i) Sections 4(1)(e) and 4(1)(l) which were mentioned briefly in respect of the discussion of rent-free holidays and rent discounts, could apply to an incentive in the form of a low interest or interest free loan provided by a company (the lessor) to a shareholder, or associated person to lease premises.

The value of the dividend will broadly be the difference between one of a number of benchmark rates prescribed by the Act and the actual rate paid, if any.

Again, it is unlikely that these provisions will apply to most lease incentives of this kind because as noted earlier most lease arrangements are made with arm's length lessees.

(ii) There may be an argument based on *Cooke & Sherden* that there is no assessable benefit to the recipient of an interest free loan because:<sup>18</sup> "income is what comes in, it is not what is saved from going out. A non-pecuniary receipt can be income if it can be converted into money; but if it be inconvertible, it does not become income merely because it saves expenditure".

In respect of the receipt of an interest free loan, no income is derived by the lessee. Instead, as a result of the interest-free loan the lessee saves expenditure in the form of interest which may otherwise have been incurred.

The issue in respect of this type of benefit is whether it is convertible to cash. If the lessee had been offered the option of cash, or an interest free loan, then arguably the benefit is convertible and may be assessable. If however, this was the only type of incentive made available in the negotiations for the lease of property, the benefit may not be convertible.

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<sup>17</sup>IT 2631 *Income Tax: Lease Incentives*, Supplement to (1991) 25 *Taxation in Australia*, No. 11, R47.

<sup>18</sup>80 A.T.C. 4140 at p. 4149.



(iii) The accrual rules may also apply in certain circumstances, depending on the term of the loan and other factors.

(6) Free Fit-Out

(a) The Ruling. The ruling states the treatment for tax purposes of a free fit-out depends on whether the ownership of the fit-out passes to the tenant or remains with the landlord.

(i) Ownership by the lessor. Where the ownership of the fit-out remains with the landlord, the only benefit received by the tenant is the use of the fit-out during the lease term. This benefit has some value to the tenant, presumably equivalent to a reduction in the rent payable. Payments for the use of a fit-out, as with the payment of rent, generally would have a revenue character and be fully deductible. As such, the benefit will be effectively tax-free by virtue of the application of subsection 21A(3) - the "otherwise deductible" rule.

The ruling appears to link a free fit-out with the level of rent charged. If a free fit-out were not provided the rental charged would be less by an equivalent amount.

(ii) Lessee Ownership of the Fit-out. The situation is different where the lessee is given ownership of the fit-out. The benefit is assessable to the lessee. If the tenant incurred expenditure in relation to the acquisition of the fit-out, that expenditure would be of a capital nature. As such, the "otherwise deductible" rule would not apply to reduce the value of the benefit to be included in assessable income. However, the tenant would be entitled to deductions for depreciation to the extent that the fit-out qualified as depreciable plant or articles.

The ruling briefly makes mention of capital gains tax consequences on the sale of the asset (the fit-out).

(iii) Rules to Determine Ownership. In respect of ownership for the purposes of applying the above, the ruling continues by stating it will be considered that the landlord has retained ownership of fixtures which were affixed by the landlord.

If the lessee has a contractual right to remove the fixtures, the lessee has a valuable interest in the fixtures akin to ownership. For the purposes of section 21A, the value of that interest in the fixtures is considered to be the fit-out cost. To the extent the fit-out qualifies as depreciable plant or articles, the lessee would be entitled to claim a deduction for depreciation.

In the situation where the lessee has a contractual obligation to remove the fixtures, but the landlord directs that the items are to remain on the premises, the landlord will be considered to have retained the ownership in the fixtures.

(iv) Where the fit-out is paid with a cash incentive. If when the parties negotiate a lease incentive, they agree that a certain percentage of a cash lease incentive would be expended on a fit-out and, the fit-out will be the property of the lessor, with the result that the lessee receives an amount net of the agreed fit-out costs, only this net amount would be treated as assessable income to the lessee.

However, if after receiving a cash incentive from the lessor, the lessee paid for the fit-out, the lessee will be considered to have derived an assessable amount that is equal to the full cash incentive. The ruling does not elaborate on this point. Support for this view is however found in the Australian case of *G.P. International Pipecoaters Pty. Ltd. v. F.C. of T.*<sup>19</sup> In that case, money paid to the taxpayer and used to construct a pipe-coating plant was assessable income, even though it was applied by the taxpayer to the construction of a capital asset. The Court said what was important was the quality of the receipts in the recipient's hands, not the purpose to which the receipts were subsequently applied.

Where the lessee has responsibility for the fit-out and the lessor pays some or all of the fit-out costs to the contractor, the constructive receipt provisions of section 19 of the Australian legislation would apply, with the result that the lessee would be taken to have derived an assessable amount equal to those payments and any cash incentive that was paid.

(b) Neilson and Still.

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<sup>19</sup>90 A.T.C. 4413.

(i) Fit-out provided and owned by lessor. The authors<sup>20</sup> believe it unlikely section 25(1) or 21A of the Australian Tax Act would apply to a fit-out provided by and owned by the lessor, as long as rent is paid by the lessee for the fully fitted out premises. The conclusion is similar to the ruling.

Conversely, if the arrangements were structured in such a way that the lessee obtained the use of the fit-out which remained the property of the lessor, and the lessee did not pay any rent or fee for its use, the lessee arguably would have derived assessable income under section 21A of the Australian Act. If this were the case, it would appear that section 21A(3) would only operate to reduce the assessable income arising from the right to use the fit-out if that right was for a period of less than 13 months.

(ii) Fit-out Ownership granted to lessee. If the lessor paid for the fit-out and then grants the ownership to the lessee, as against a mere right to use, this would result in the lessee deriving assessable income, at least under section 21A, if not under the general principles expressed in *Cooling's* case. This also agrees with the ruling.

(iii) Contractual Terms in Respect of the Fit-out. Where the lessor owns the fit-out, the lease may require the lessee to remove parts of the fit-out at the expiry of the lease. Alternatively the lessor could have a put option to sell the fit-out to the lessee, usually for a written down value, at the end of the lease. Effectively in this situation the lessor has placed the removal obligations on the lessee.

Aside from any special provisions that may affect the option, the authors consider that such terms of a lease should not affect the application of the principles that have been discussed to this point. The sale of the fit-out to a lessee under a put option may be regarded as a non-cash business benefit, but given that the removal of the fit-out from the premises is regarded as being onerous and such a fit-out may not be of much use after the removal, such a "benefit" probably would have little or no arm's length value.

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<sup>20</sup>Still & Neilson, *Taxation Implications of Lease Incentives*, The C.C.H. Journal of Australian Taxation: December 1990/January 1991, pp. 10-11.

They also raise another issue concerning the control over the design of the fit-out where the lessor undertakes to provide fully fitted out premises.<sup>21</sup> A lessee may be given certain rights, and even responsibilities concerning the design of the fit-out. Some concern was expressed to the authors by construction law colleagues, that giving the lessee any control over the fit-out could constitute or evidence some form of benefit that could be subject to tax under section 21A.

The authors consider that section 21A would not deem a lessee to derive assessable income merely because the lessee was successful in negotiating a term in the lease which required a particular design of fit-out. This view assumed that the lessor owned the fit-out, and the rental obligations of the lessee were an arm's length consideration for the right to occupy the fitted out premises for the term of the lease. Still and Neilson believe that section 21A should not deem assessable income to have arisen merely because of the granting to the lessee the power to exercise some control over the subsequent fitting out of the premises.

They however comment that, due to the very wide definition in section 21A of "services",<sup>22</sup> which may constitute a "non-cash business benefit", it is impossible to state categorically that this type of control could not constitute a "non-cash business benefit".

Due to the uncertainties surrounding the concept of income which has increased with *Cooling's* case and the lack of authority on section 21A, Still and Neilson<sup>23</sup> state it would not be surprising if parties continue minimising the degree of control exercised by a lessee over the fit-out, particularly after the lease has been entered into.

They note that the practice in Australia, (and presumably also in New Zealand), is that lessors rarely agree to provide the fit-out whatever it will cost. Usually the lessor will agree to expend money on a fit-out to an agreed cap, over

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<sup>21</sup>Ibid., p. 11.

<sup>22</sup>Ibid., p. 12.

<sup>23</sup>Ibid., p. 12.

which it is the responsibility of the lessee to complete the fit-out. Any mismatch between the ownership of the fit-out items and expenditure on those items obviously should be avoided, otherwise the owner of that fit-out item could be said to have derived assessable income arising from the "benefit" of being given ownership of the item. Insofar as depreciation of the fit-out is concerned, it would be preferable for the owner of the fit-out to have paid for the same.

The authors conclude,<sup>24</sup> in all these cases the exact terms negotiated between the parties should be considered. As each large lease is often tailor-made for the particular tenancy, slightly different tax issues will be raised.

(c) New Zealand

(i) Ownership by Lessor. Where the fit-out is owned by the landlord, as in Australia, the landlord can claim depreciation on the fit-out. The only income tax implication for the lessee is presumably payment of a higher rent than if the lessee had paid for the fit-out and the lessee will be unable to claim a deduction for depreciation on the fit-out items.

(ii) Fit-out provided to lessee. Where the lessor (a company) pays for the fit-out and then gives the lessee the fit-out, if the lessee is a shareholder (or an associated person of a shareholder) in the lessor, again sections 4(1)(e) or (l) may deem this to be a dividend.

In arm's length lease transactions if the benefit (fit-out) is convertible, the benefit may be assessable to the lessee as income from carrying on a business or income according to ordinary concepts. This raises similar issues concerning assessability to those in respect of the tax treatment of a cash incentive. If title to the fit-out is given to the lessee, there is an argument that the lessee will be entitled to claim a deduction for depreciation on the fit-out items.

In certain situations there may also be gift duty implications for the lessor if the value of the fit-out or fit-outs provided exceeds \$27,000 in any one year, as will often be the case.

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<sup>24</sup>Ibid., p. 12.

(iii) Funds Provided for Fit-out. It is arguable whether cash provided by a lessor to a lessee for expenditure on the fit-out is, or is not assessable. The essential test is the quality or character of the receipt in the hands of the recipient: *Scott v. F.C. of T.*<sup>25</sup>

In *C. of I.R. v. City Motor Service Ltd., C. of I.R. v. Napier Motors Ltd.*<sup>26</sup> North P. said:

I find it impossible to accept the view that because a third party regards it as commercially profitable to make a contribution to the cost of the erection or reconstruction of a customer's premises that the contribution is to be regarded as income received by the customer at all events unless the arrangement is a tax avoidance scheme...

His Honour found support for this from *Boyce (H.M. Inspector of Taxes) v. Whitwick Colliery Co. Ltd.*<sup>27</sup>

On the basis of this case, where the lessor pays either the fit-out contractors directly, or the lessee who applies the funds to the fit-out, it is unlikely the receipt would be assessable.

However, in the Australian case *G.P. International Pipecoaters Ltd.*, payments made to the taxpayer for the construction of a pipe-coating plant were assessable to the taxpayer. In this case the decision in *Boyce* was firmly rejected by the court. If *G.P. International Pipecoaters* were followed, any payment made to the lessee by the lessor could be assessable. The case did not discuss the situation where a payment is made directly to another party other than the taxpayer.

#### (7) Free Plant

(a) The Ruling. The ruling provides the arm's length value of plant or articles such as computers given to the lessee will be assessable to the lessee pursuant to subsection 21A(2), being a non-cash business benefit received by the lessee. However the lessee will be entitled to claim deductions for depreciation.

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<sup>25</sup>(1966) 117 C.L.R. 514.

<sup>26</sup>[1969] N.Z.L.R. 1010 at p. 1014.

<sup>27</sup>[1934] All E.R. 706 at p. 714.

(b) Neilson and Still<sup>28</sup> comment that items such as cars and boats have been provided as incentives for lessees to enter into a lease. Such incentives would be convertible into cash and following from the principles in *Cooling's* case would therefore constitute assessable income, presumably on the basis that the incentive is received in the course of the taxpayer's activities.

(c) New Zealand. While New Zealand does not have an equivalent to section 21A, the principles in *Tennant v. Smith* and *F.C. of T. v. Cooke & Sherden* are good law in New Zealand. If the plant is convertible to cash the benefit may either be business income or income according to ordinary concepts. In this respect, if the plant is convertible the issues concerning its assessability will be similar to those concerning the tax treatment of a cash incentive. The ruling cites a car or boat as examples of non-cash incentives that are convertible to cash.

Alternatively in certain situations the dividend provisions discussed earlier could apply.

#### (8) Holiday Packages

The lessor may offer a holiday package to potential lessees to enter into an agreement to lease premises.

(a) The Ruling. Subsection 21A(4) of the Income Tax Assessment Act reduces the taxable value of a non-cash business benefit to the extent that any expenditure incurred in providing the benefit is disallowed by the operation of section 51AE which deals with entertainment expenses. For the purposes of subsection 21A(4) the cost of complete holiday packages comprising travel, accommodation, meals and recreation provided as an incentive to enter a lease would be treated as being non-deductible. The question of whether incentives in the form of travel or travel and accommodation are non-deductible entertainment expenses could only be determined on the facts of each case.

Accordingly the incentive will effectively be tax free to the tenant.

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<sup>28</sup>Still & Neilson, *Taxation Implications of Lease Incentives*, The C.C.H. Journal of Australian Taxation: December 1990/January 1991, p. 12.

(b) New Zealand. The case law on the concept of income will determine whether the benefit will be taxable. As noted *F.C. of T. v. Cooke & Sherden* considered the assessability of holidays. The Full Federal Court in that case summarised by saying:<sup>29</sup> "If a taxpayer receives a benefit which cannot be turned to pecuniary account, he has not received income as that term is understood according to ordinary concepts and usages".

If however the free holiday can "be turned to pecuniary account" the benefit may then be assessable in the hands of the recipient either under section 65(2)(a) or as income according to ordinary concepts. As with plant provided to a lessee if the holiday is convertible, the issues concerning its assessability will be similar to those concerning the tax treatment of a cash incentive.

#### (9) Removal Expenses

As an inducement to sign a lease, the lessor may offer to pay the removal expenses of the prospective lessee from their existing premises.

(a) The Ruling. Removal expenses, except those relating to the transport of trading stock are not deductible as they have a capital nature: *Granite Supply Association Ltd. v. Kitton*,<sup>30</sup> *Lister Blackstone Pty. Ltd. v. F.C. of T.*<sup>31</sup> and *Case 47*.<sup>32</sup> Generally therefore there will be no reduction under subsection 21A(3) in relation to lease incentives in the form of removal expenses paid for by the lessor.

Accordingly except to the extent that the removal costs relate to revenue items such as trading stock, the payment will be taxable.

(b) New Zealand. A general principle is that "if the receipt of an item saves a taxpayer from incurring expenditure, the saving is not income; income is what comes in, it is not what is saved from going out.": *Cooke & Sherden*. Therefore

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<sup>29</sup>80 A.T.C. 4140.

<sup>30</sup>(1905) 5 T.C. 168.

<sup>31</sup>76 A.T.C. 4285.

<sup>32</sup>18 C.T.B.R. (N.S.).



if the lessor paid directly for the removal expenses or a part thereof I do not believe this would be assessable to the lessee.

The discussion of the *City Motor's* case and fit-outs (at (6)) is also relevant. On the basis of that case it is unlikely removal costs paid directly by the lessor to a third party would be an assessable benefit to the lessee.

Where the payment was made to the lessee and it was not specifically allocated or tied to the reimbursement of removal costs, whether it is assessable is less clear, the issue being the quality of the receipt in the lessee's hands. The payment in this instance is in effect a cash incentive. If the lessee is bound to apply the payment to the costs of moving, based on the *City Motor's* case, there may be an argument that the payment is not assessable.

#### (10) Surrender Payments

Payments of this nature, may occur where the taxpayer is leasing premises and the lease has a number of years to run. A lessor makes a payment either to the taxpayer's existing landlord for the surrender of the lease, or to the taxpayer, who negotiates with the existing landlord for the surrender of the lease and applies the payment accordingly.

(a) The Ruling. If a payment had been made by the lessee to a former lessor as consideration for the surrender of a lease, the lessee would not have been allowed a deduction: *Cowcher v. Mills and Co.*,<sup>33</sup> *West African Drug Co. v. Lilley*<sup>34</sup>. Accordingly, the full amount of any lease incentive payment made by the new lessor to a former lessor for the surrender of an existing lease, would be included in the assessable income of the lessee without reduction by subsection 21A(3).

The ruling does not deal with a payment made directly to the lessee. Presumably this would be assessable as a cash incentive per the principles in *Cooling*.

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<sup>33</sup>(1927) 13 T.C. 216.

<sup>34</sup>(1947) 28 T.C. 140.

(b) New Zealand. In the New Zealand case of *C. of I.R. v. McKenzies N.Z. Ltd.*<sup>35</sup> the Court of Appeal held a lump sum payment made by the lessee to surrender a lease was a capital item and not deductible. This is supported by the recent Australian case of *Kennedy Holdings and Property Management Pty. Ltd. v. F.C. of T.*<sup>36</sup>

This agrees with the first part of the Australian Tax Ruling concerning deductibility. However in New Zealand we have no section 21A(3). The arguments concerning the treatment of such a payment are similar to those in respect of removal expenses and may depend on who receives the payment - the existing landlord or lessee.

If the payment is made directly to a third party, the existing landlord, based on *North P. in City Motor's* it is unlikely the amount will be assessable to the lessee. In addition, as far as the lessee is concerned the payment to the landlord does not become income simply because it saves expenditure.

Where the payment is to the lessee the issue is the quality of the receipt in the lessee's hands. If the reasoning in *G.P. International Pipecoaters* were followed, the payment could be assessable. If the lessee is bound to apply the money to terminate the lease, on the basis of *City Motor's* the payment may not be assessable. The cases of *McKenzies* and *Kennedy Holdings and Property Management* may assist in arguing that a payment made to the lessee is not assessable.

#### (11) Value Of The Benefit

The ruling continues by discussing the value of the benefit. In some circumstances it will be necessary to value the benefit. Where section 21A applies, it is the "arm's length value" of the incentive that is assessable. The arm's length value is defined to mean the amount that the recipient could reasonably expect to pay to obtain the benefit from the provider under a transaction where the parties to the transaction are dealing with each other at arm's length. Alternatively if no amount

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<sup>35</sup>(1988) 10 N.Z.T.C. 5233.

<sup>36</sup>92 A.T.C. 4918.

can practically be determined, such an amount as determined by the Commissioner to be reasonable.

In determining the arm's length value of the benefit, any conditions which would prevent or restrict the benefit's conversion to cash should be disregarded. The ruling states in practice the "arm's length value" will normally be the amount that would be paid on the open market from a supplier of those particular goods or services.

Where section 21A does not apply, the "money value" of the benefit will be deemed to have been paid to the lessee.

#### (12) Conclusion

The ruling gives some insight into the possible treatment by the New Zealand Inland Revenue Department of various forms of lease incentives in the hands of the lessee. The rulings application to New Zealand is limited however, because there is no equivalent in our legislation to section 21A of the Income Tax Assessment Act on which much of the ruling is based. In New Zealand the determination of whether a particular lease incentive will be assessable to the lessee will rest far more on case law and accordingly the treatment for tax purposes is currently that much less certain.

## 2. THE DEDUCTIBILITY OF THE PROVISION OF AN INCENTIVE

### (1) Introduction

In this section I discuss briefly whether a lease incentive provided by the lessor to lessee (or a third party) will give rise to a deduction to the lessor. The Australian Tax Office Ruling deals briefly with this and is the starting point for this discussion.

### (2) The Ruling

In Australia the provision of a lease incentive will usually give rise to an allowable deduction for the lessor pursuant to section 51(1) of the Income Tax Assessment Act. Section 51(1) provides:

All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.

Section 51 is equivalent to section 104 of the New Zealand Income Tax Act 1976. The deductibility of the lease incentive flows from the characterisation of the outgoing as being incurred for the purpose of gaining or producing assessable income.

The ruling however states such a conclusion may not be appropriate where the true purpose of providing the lease incentive was not to induce the lessee to enter into a lease. In such situations it might be appropriate to apply Part IVA of the Income Tax Assessment Act. The ruling states that examples of Part IVA's application might include the purposes of benefiting an associate or shifting income to an associate who has carry forward losses. Such cases depend on their particular facts including the degree of association that exists between the parties, the parties relative financial positions and whether it is possible to characterise the incentive as being at arm's length.

The conclusion that lease incentives will generally be deductible would not be appropriate for the following incentives:

(a) Where the ownership of the fit-out is retained by the landlord. In that

case there is no allowable deduction pursuant to subsection 51(1) as the expenditure is of a capital nature. Depreciation could be claimed in respect of plant or articles.

(b) When the incentive is a rent free holiday or a rent discount. The lessor will not be permitted a deduction for the rent forgone as it is not possible to characterise it as a loss or outgoing incurred: *C. of T. v. Antill*.<sup>1</sup>

(c) As outlined earlier, section 51AE of the Australian tax act may apply to prevent a deduction being allowed where the incentive is in the form of a complete holiday package or some other entertainment.

### (3) New Zealand: The general test of deductibility

As already discussed section 104 provides that a deduction is permitted for:

...any expenditure or loss to the extent to which it -

(a) Is incurred in gaining or producing the assessable income for any income year;

or

(b) Is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year...

There are a number of basic concepts contained in section 104 in order for a deduction to be allowable. Specifically:

(a) There must be a sufficient relationship between the expenditure and the income-earning process for the expenditure to be deductible under this section.

(b) A deduction is allowed only to the extent that the test of deductibility is met. Accordingly the section permits apportionment between expenditure of a revenue nature and that of a capital nature: *C. of I.R. v. Banks*.<sup>2</sup> The onus is on the taxpayer to prove the extent to which the amount claimed satisfies section 104.

(c) Deductibility of the expenditure is not determined by whether the outgoing produces income: *Ash v. C. of T. (N.S.W.)*.<sup>3</sup>

(d) There will not be a sufficient relationship between expenditure and income merely because an income-earning activity is being carried on: *de Pelichet*

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<sup>1</sup>[1902] A.C. 422.

<sup>2</sup>(1983) 3 N.Z.T.C. 61,236.

<sup>3</sup>(1938) 61 C.L.R. 263.

*McLeod and Co. Ltd. v. C. of I.R.*<sup>4</sup>

(e) The Commissioner is not bound by the description of the outgoing made by the taxpayer: *C. of I.R. v. Europa Oil (N.Z.) Ltd.*<sup>5</sup>

(4) Lease Incentives in New Zealand and Section 104

Where a lease incentive is provided by the lessor, as in Australia, depending on the type of incentive, prima facie it will be deductible. Generally an incentive will be provided for the purpose of deriving income in the form of rent (section 104(a)). If the expenditure does not fall within subsection (a), in most cases it will fall within section 104(b), i.e., it will be expenditure incurred in the carrying on a business for the purpose of deriving assessable income. This is however subject to the exclusion for expenditure of a capital nature. It should be noted the issue of deductibility is a separate one to that of assessability.

In respect of a rent holiday and rent discount, as in Australia, no deduction will be allowable as there has been no expenditure or outgoing, merely the forgoing of assessable income.

Where the lessor pays for the fit-out and the fit-out remains the property of the lessor, the fit-out is capital and not deductible. The lessor will however be entitled to claim a deduction for depreciation of that fit-out.

In respect of an interest-free loan provided out of the lessors own resources there will again be no expenditure or outgoing to deduct. Where the lessor has borrowed funds and on lent them at no interest, the question arises as to whether the interest payable by the lessor is deductible under section 106(1)(h). The tests for deductibility of interest under section 106(1)(h) are similar to the general deductibility tests under section 104. The interest cost probably would be deductible under section 106(1)(h) because the interest is necessarily payable in order to provide an incentive (an interest-free loan) to obtain a tenant from whom to derive rental income. If it were not deductible, the lessor could always restructure the borrowing

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<sup>4</sup>(1982) 5 N.Z.T.C. 61,216 p. 61,220.

<sup>5</sup>[1971] N.Z.L.R. 641.

in order to obtain a deduction.

Payments made for the termination of an existing lease following *C. of I.R. v. McKenzies N.Z. Ltd.*<sup>6</sup> and *Kennedy Holdings and Property Management Pty. Ltd. v. F.C. of T.*<sup>7</sup> would probably not be deductible if made directly to the existing lessor or lessee.

(5) A Capital Outgoing?

A lessor providing a lease incentive could be denied a deduction for the incentive by virtue of section 106(1) of the Income Tax Act if it were an outgoing of a capital nature. As previously discussed section 106(1) prohibits a deduction for expenditure or losses of a capital nature.

(a) Cash incentives. The opening words of section 106, "Notwithstanding anything in section 104 of this Act" mean while prima facie an item may be deductible under section 104 it can be denied deductibility under section 106.

Still & Neilson<sup>8</sup> point to the comments of *Dixon J.* in *Sun Newspapers Ltd. v. F.C. of T.*:<sup>9</sup>

There are, I think, three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it...

(i) "The character of the advantage sought". Still & Neilson comment that most lease incentives will be provided to secure a lease that will last for a number of years. Accordingly in respect of the lessor making the incentive, the lessor has in the words of Lord *Cave* in *British Insulated and Helsby Cables Ltd. v. Atherton*<sup>10</sup> obtained "an asset or an advantage for the enduring benefit of a trade".

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<sup>6</sup>(1988) 10 N.Z.T.C. 5233.

<sup>7</sup>92 A.T.C. 4918.

<sup>8</sup>Still and Neilson, *Taxation Implications of Lease Incentives*, The C.C.H. Journal of Australian Taxation: December 1990/January 1991, p. 13.

<sup>9</sup>(1938) 61 C.L.R. 337 at p. 363.

<sup>10</sup>[1926] A.C. 205.

This test was approved by *Dixon J.* in *Sun Newspapers*.

Still & Neilson contrast the Privy Council decision in *B.P. Australia Ltd. v. Commr of Taxation of the Commonwealth of Australia*<sup>11</sup> with the House of Lords decision in *Regent Oil Co Ltd v Strick*.<sup>12</sup> In *B.P. Australia* the appellant company promised to pay a sum of money, called a "development allowance" as part of the consideration for the service station proprietor agreeing to deal exclusively in the brands of motor spirits approved by B.P. for a fixed number of years ranging between three and fifteen. The case was argued by both sides on the basis of the average period of five years. The Privy Council held on a balance of all the relevant considerations that the scales inclined in favour of the expenditure being of a revenue nature. In the course of the decision it was stated:

What additional indication is given by the actual length of the agreements? That must be a question of degree. Had the agreements been only for two or three year periods that fact would have pointed to recurrent revenue expenditure. Had they been for twenty years, that fact would have pointed to a non-recurring payment of a capital nature. Length of time, though theoretically not a deciding factor, does in practice shed a light on the nature of the advantage sought. The longer the duration of the agreements, the greater the indication that a structural solution was being sought. In this case the periods varied between three and fifteen years, but the average appears to be something just under five years and the predominant number of agreements was for a five-year period. The case was argued before their Lordships as in the courts below on the footing that five years was the length of the tie ... That length of time appears to be neutral, and in itself indicates neither capital expenditure nor revenue by its mere length. It therefore does not add effectively to the argument either way. The question must be decided by other weights in the balance.<sup>13</sup>

*Regent Oil Co. Ltd. v. Strick* also concerned exclusive trade tie agreements in return for lump sum payments. Of the lease under which the capital payments were made, one was for a period of ten years and two for terms of twenty-one years. In addition there was a relatively minor payment that was made in relation to a five-year lease. Their Lordships each found the payments to be capital. They each considered that the length of time covered by the arrangements was relevant to the character of the payment.

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<sup>11</sup>[1966] A.C. 224.

<sup>12</sup>[1966] A.C. 295.

<sup>13</sup>[1966] A.C. 224 at p. 267.



Lord *Reid* in *Strick* commented:<sup>14</sup> "I would have great difficulty in regarding a payment to cover twenty years as anything other than a capital outlay". He went on to observe:

A business cannot simply be managed on a day-to-day basis. There must be arrangements for future supplies and sales, and it may not be unreasonable to look five or six years ahead - one hears of five-year plans in various connections. So I would think that making arrangements for the next five or six years could generally be regarded as an ordinary incident of marketing, and that the cost of making such arrangements would therefore be part of the ordinary running expenses of the business. Moreover a payment which will have to be repeated after five years to retain the tie can I think be regarded as a recurring payment; and there is no serious distortion of the profit and loss payment for that period if payment for a five-year advantage is made in a lump sum instead of being spread over the period.

Still & Neilson<sup>15</sup> comment that each case will depend on its own facts and the size and scope of the "advantage" that is obtained relevant to the particular lessor's business. They believe that the cases do however indicate that the longer the lease period, the more likely it is that the incentive would be denied deductibility by virtue of it being classified as capital.

It should be noted that the length of time is only one factor which would be examined in determining whether a lease incentive was of an income nature and therefore deductible or of a capital nature and not deductible.

(ii) "The manner in which it is to be used, relied upon or enjoyed". In respect of criterion (b) of *Dixon J.*'s list, the authors comment that a number of factual matters would need to be considered. These would include whether the lessor proposes to sell the premises in the shorter term and the frequency of such leasing transactions in relation to the business of the lessor.

Arguably if the lessor is frequently involved in such transactions it is more likely that the lease incentive will be of an income nature. In *McKenzies'* case it was stated if leases were regularly traded they could form trading stock or be regarded as circulating capital.

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<sup>14</sup>[1966] A.C. 295.

<sup>15</sup>Still and Neilson, *Taxation Implications of Lease Incentives*, The C.C.H. Journal of Australian Taxation: December 1990/January 1991, p. 13.

(iii) "The means adopted to obtain it". Criterion (c) in such cases, they suggest would point to the payment being capital because of its "one-off" nature.

Still & Neilson<sup>16</sup> again stress each case depends on its own facts. They comment it cannot be assumed (in Australia at least) that all cash lease incentives will be deductible because of *Cooling's*<sup>17</sup> case.

Since Still & Neilson wrote their article *Kennedy's* case has been decided. In that case a payment made by the lessors to terminate a lease was held to be a capital payment and not deductible. Given this case and *McKenzies'* case which held a payment by the lessee to terminate a lease was capital, cash incentives provided by the lessor may not be deductible, notwithstanding that section 104 concerning general deductibility is satisfied.

(b) Non-Cash Incentives. In the case of a non-cash lease incentive Still and Neilson<sup>18</sup> comment, "even less can it be assumed" that the lessor will be an allowed a deduction. Each type of non-cash incentive needs to be looked at individually. In determining whether expenditure incurred in respect of the provision of a lease incentive is of a capital or revenue nature, similar considerations will apply as to cash incentives.

#### (6) Conclusion

(a) The ruling states the provision of a lease incentive will usually give rise to an allowable deduction.

(b) In New Zealand the same general statement can probably also be made, depending on the form the incentive takes and length of lease given in consideration for the incentive.

(c) The ruling does not however discuss whether a deduction could be denied a lessor on the basis that the expenditure in relation to the incentive was of a

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<sup>16</sup>Ibid., p. 14.

<sup>17</sup>*F.C. of T. v. Cooling* 90 A.T.C. 4472.

<sup>18</sup>Still and Neilson, *Taxation Implications of Lease Incentives*, The C.C.H. Journal of Australian Taxation: December 1990/January 1991, p. 14.

capital nature. Still and Neilson believe this to be a real possibility. In New Zealand, given the strong statements by *Richardson J.* in *McKenzies* a lease is generally a capital item, there are grounds for concern on this point.

(d) The three matters listed by *Dixon J.* in *Sun Newspapers Ltd. v. F.C. of T.* may together indicate the cost of an incentive is expenditure of a capital nature.

## CHAPTER III

### NEW ZEALAND CASES

#### INTRODUCTION

Chapter I of this part of the thesis discussed the provisions of section 65(2) with respect to whether an incentive provided to a taxpayer to enter into a lease of premises could be assessable.

Chapter II discussed the Australian tax ruling on the assessability and deductibility of lease incentives in an attempt to gain some insight into the possible treatment by the Inland Revenue Department of various forms of lease incentives.

In this chapter I discuss several New Zealand decisions on the income - capital distinction. In New Zealand there have been no cases decided directly on the assessability of lease incentives. An indication of the approach the Taxation Review Authority and New Zealand courts could take in respect of the tax treatment of an incentive may however be gauged from;

(a) the general approach of the courts to distinguishing between items of an income nature and those of a capital nature, and

(b) the manner in which the antithesis of a lease incentive, a payment to terminate a lease obligation has been examined by the New Zealand Court of Appeal.

1. *C. of I.R. v. CITY MOTOR SERVICE LTD;*  
*C. of I.R. v. NAPIER MOTORS LTD.*<sup>1</sup>

(1) Introduction

These two cases were heard together by *North P.*, *Turner J.* and *McCarthy J.* in the Court of Appeal. Each case arose from an appeal from the judgment of *Henry J.* in the Supreme Court.

The significance of these decisions for this thesis is twofold. Their Honours discuss both the income-capital distinction, and also the meaning of the word "business" as used in the predecessor to section 65(2)(a) of the Income Tax Act 1976.

(2) The Facts

(a) The City Motor's Case. City Motors carried on the business of motor vehicle dealers and garage proprietors in Dunedin. They decided to establish a branch at Mosgiel. Mobil Oil New Zealand wanted to further the sale of its products in Mosgiel. Mobil learned of City Motor's intention to establish a branch in Mosgiel. Mobil arranged with City Motors that Mobil would have certain work done which it thought necessary to equip the new branch to handle its products. This would be done at Mobil's expense. There was no contract between the parties that if Mobil did this City Motors would undertake to sell its products exclusively, or for a given period or at all, although no doubt, *Turner J.* said it was understood that this would be the likely result. In this regard the work on the service station included painting it in the distinctive colour scheme that was adopted by Mobil stations.

Mobil paid the contractors and others involved in the work directly. No part of the contribution ever reached City Motors.

(b) The Napier Motors' Case. Napier Motors Ltd carried on business as a motor vehicle dealer in a very old building in Dunedin. It sold petrol to its customers and also to the public at large. Kerbside pumps had been erected for this purpose. The Dunedin City Corporation required the pumps to be removed from the footpath

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<sup>1</sup>[1969] N.Z.L.R. 1010.

and re-erected inside or adjacent to the building. The taxpayer apparently was of the opinion that the cost involved in substantially altering the old building could not be economically justified. It was therefore proposed to vacate the building and move its pumps to another site owned by it.

This did not however suit B.P.(N.Z.) Ltd who were interested in having its products sold from the old site. B.P. therefore endeavoured to persuade Napier Motors to incur the expenditure necessary in reconstructing the old building. It was found that the estimated cost was 5000 pounds. B.P. offered to contribute 2500 pounds to the cost. B.P. paid two amounts directly to Napier Motors Ltd in the income years ending 31 May 1961 and 31 May 1962 respectively. Each payment was a partial reimbursement by B.P. of costs incurred by Napier Motors in those income years in fitting out its service station in order to meet B.P.'s requirements for the sale of its products.

The distinction here from the *City Motor's* case is that the sums the subject of this case were paid by B.P. to Napier Motors and not to third parties. The payments were made expressly by way of partial refund of amounts which had been paid out for the purposes stated.

The broad question before *Henry J.* in the two cases had been whether the payments made were assessable to the retailers.

(3) North P.

At the outset his Honour stated both appeals must fail because in each case the contribution that was made by each oil company concerned was of a capital nature and was not to be regarded in the taxpayer's hands as profits or gains derived from their businesses.

*North P.* referred to the English decision of *Strick (Inspector of Taxes) v. Regent Oil Co. Ltd.*<sup>2</sup> in particular the comment of Lord *Reid*: "What a persons spends to set up a business must be capital; there cannot be a revenue expense until trading commences..."

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<sup>2</sup>[1966] A.C. 295.

*North P.* believed that the contribution made by Mobil in the *City Motor's* case was made before the Mosgiel business of City Motors commenced. In the *Napier Motors'* case he likewise believed a new start to the business was proposed and accordingly he believed he was entitled to view the matter in much the same way. Whether or not that was so he was confident that if City Motors and Napier Motors had expended the sums of money the subject of the cases themselves they would have been treated as capital expenditures incurred for the purpose of creating a capital asset.

I find it impossible to accept the view that because a third party regards it as commercially profitable to make a contribution to the cost of the erection or reconstruction of a customer's premises that that contribution is to be regarded as income received by the customer at all events unless the arrangement is a tax avoidance scheme and nothing like that is suggested here.<sup>3</sup>

While the contribution made by Mobil never reached City Motors the contribution from B.P. was paid directly to Napier Motors. However:

...it cannot be doubted that the company was obliged either as an express or implied term of the arrangement to expend the money on the reconstruction of a capital asset. If Napier Motors Ltd had failed to apply the amount for the purpose for which it was paid and had attempted to divert it to revenue it certainly would have been guilty of a breach of the arrangement and could, I imagine, have been reached by the Court in appropriate proceedings.<sup>4</sup>

His Honour made reference to *Boyce (H.M. Inspector of Taxes) v. Whitwick Colliery Co. Ltd.*<sup>5</sup> where a not dissimilar arrangement was made between a district council and colliery company. The district council made a contribution to the cost of constructing certain water works, which even though it was paid to the colliery company over a period of years, was held to be a repayment of the capital cost of the works and therefore the payments were capital receipts in the hands of the colliery company.

*North P.* cites (at 1014) *Romer L.J.* in *Boyce* who said, when dealing with a

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<sup>3</sup>[1969] N.Z.L.R. 1010 at p. 1014.

<sup>4</sup>*Ibid.*, p. 1014.

<sup>5</sup>[1934] All E.R. 706.

related matter:<sup>6</sup> "A taxpayer can make a capital expenditure upon the land of a third party; it is none the less, a capital expenditure even if it is upon the land of a third party and not upon his own land." Obviously the expenditure has to be of a capital nature in the first place.

His Honour was of the view that there was no reason why a different principle should be applied in the present case and accordingly both appeals failed.

The decision of *North P.* can be contrasted with the recent Australian decision *G.P. International Pipecoaters Pty. Ltd. v. F.C. of T.*<sup>7</sup> which illustrates a different approach to the matter. In that case, as already discussed, "establishment costs" paid to the taxpayer for the construction of a plant were held to be assessable to the taxpayer as the payments were received in the ordinary course of the business carried on by the taxpayer. The construction of the plant was an integral part of the work the taxpayer was required to perform under the contract.

The taxpayer argued that as the payments received were for the purpose of expenditure in the construction of the plant, they were of a capital nature. Their Honours however said this assumed that the receipts character was necessarily determined by the character of the proposed expenditure of the recipient. Such an assumption was erroneous. The taxpayer in *G.P. International Pipecoaters* cited two cases to the Court, one of which was the *Boyce* case. Their Honours believed *Boyce* was not sound in principle and in their opinion should not be followed in Australia.

Their Honours in *G.P. International Pipecoaters* said:

But it cannot be accepted that an intention on the part of a payer and a payee or either of them that a receipt be applied to recoup capital expenditure by the payee determines the character of a receipt when the circumstances show that the payment is received in consideration of the performance of a contract, the performance of which is the business of the recipient or which is performed in the ordinary course of the business of the recipient.

The wide description in that case by their Honours of the taxpayer's business brought the payments to income.

It appears the *City Motor's* case is still good law in New Zealand. As

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<sup>6</sup>Ibid., 714.

<sup>7</sup>90 A.T.C. 4413.



discussed in the section on the Australian ruling *North P.*'s statements may be applicable to several forms of lease incentive.

(4) *Turner J.*

It was submitted by the Commissioner before *Henry J.* in both cases that whatever was assessable as income in the hands of the taxpayer company was assessable under section 88 of the Land and Income Tax Act 1954.

The section provided that the assessable income of any person shall be deemed to include:

"(a) All profits or gains derived from any business...". The equivalent section in the Income Tax Act 1976 is section 65(2)(a) which uses the same wording.

*Turner J.* said the issue before the Court was whether the amounts stated by the Commissioner to be income were in each case profits or gains that were derived by the taxpayer company from its business.

*Turner J.* believed it necessary to be clear what was contended to be assessable. In the *City Motor's* case Mobil paid the moneys directly to contractors and others concerned. Those moneys could not themselves constitute a profit or gain derived by City Motors. City Motors never received the moneys or a part thereof.<sup>8</sup>

...nor [could] it be said, in this case, that it received any *equivalent* benefit, for what was expended was expended not to meet their requirements, but the requirements of Mobil...in this case it was Mobil, not City Motors, who called the tune as to what was necessary or desirable - it employed, for instance, its own architect and paid him for his supervision of its interests.

His Honour found it impossible in the circumstances to hold that the moneys paid over were ever derived by City Motors. If City Motors derived anything "it must be some increase in the value of its property after the work was done."<sup>9</sup>

In respect of the situation concerning Napier Motors it was contended that the moneys paid over to the taxpayer were themselves "gains" derived from its business, and accordingly assessable.

His Honour turned first to look at the *Napier Motors'* case and whether the

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<sup>8</sup>[1969] N.Z.L.R. 1010 at pp. 1016-1017.

<sup>9</sup>*Ibid.*, p. 1017.

moneys paid to Napier Motors were profits or gains derived from its business. Clearly the moneys were a monetary receipt, which were derived by the company. If the gain "was derived *from the business of the company*" it must be a "gain" that was assessable. The question therefore facing his Honour was whether the gain was derived "from the business of the company". This question was at the core of the Australian decisions discussed earlier including *F.C. of T. v. Cooling*.<sup>10</sup>

*Turner J.* noted the difficulty in stating any infallible test in plain clear words by which this question in all cases could be resolved. He cited *Henry J.*'s comments:<sup>11</sup>

The logical difficulty which I find ever recurrent when discussing this topic is that 'but for' the sale of Mobil products the addition would not have been made at the expense of Mobil. City Motors got the gain because it intended, and in fact gave objective proof that it intended, to deal solely in Mobil products, but, of course, without either expressly or impliedly so undertaking. Does this so identify the gain with the profit-making activities that it ought to be considered a gain additional to that which City Motors would get from the sale of Mobil products?

Although not altogether free from doubt on that point *Henry J.* believed the balance substantially favoured a capital gain. "The result of the expenditure is not directly or indirectly related to the products sold."

The same difficulty can be said of the receipt of a lease incentive, 'but for' the fact that the recipient is in business, for example as a solicitor, and will lease and carry on the business from premises for which an incentive is provided, the incentive would not have been provided to that person. Had the recipient not been in business no premises would have been required, the recipient and landlord would never have met, and no incentive would ever have been offered.

After quoting *Henry J.*, Mr Justice *Turner* believed he could do no more than reach *Henry J.*'s conclusion using other words. In *Turner J.*'s opinion the words "from the business" of the company meant something more "than merely 'as a result of the fact that the company was carrying on this business'. I think that *from the business*

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<sup>10</sup>90 A.T.C. 4472.

<sup>11</sup>[1969] N.Z.L.R. 1010 at p. 1017.

must mean *from the current operations of the business*."<sup>12</sup> This is a more narrow view of the concept of business than we saw in the Australian decisions of *Myer*<sup>13</sup> and *Cooling*.

His Honour briefly discussed the Australian and New Zealand statutes with reference to the distinction between capital accretions and revenue operations. He concluded, "without difficulty that the words 'from any business' must mean 'from the current operations of any business' and no more".<sup>14</sup>

The words "from any business" were not in his opinion apt to include accretions to capital assets of a taxpayer which, although they might result from the fact of carrying on business, "do not arise from the actual current operations of that business." *Turner J.* believed this principle formed the true basis of the judgments of the majority in the Australian High Court case *Dickenson v. F.C. of T.*<sup>15</sup>

In *Dickenson* two substantial cash payments were made in return for a "tie" of five years during which time the station-owner bound himself to sell only the products of the oil company that made the payments. This was the main factual consideration upon which the members of the majority of the High Court rested their decisions. However two of the members of the majority in the case expressly rested their ultimate conclusions on the ground that it was necessary that the payments had been the product of current operations.

*Dixon C.J.* said:<sup>16</sup>

There is nothing recurrent in the nature of the payment. *It is not a normal or actual incident of carrying on such a business and it does not represent a purpose for which such a business is carried on.* I think therefore that the sum ought not to be treated as a profit of the existing business.

The Commissioner in *Dickenson* contended that the two payments made by

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<sup>12</sup>*Ibid.*, p. 1017.

<sup>13</sup>*F.C. of T. v. The Myer Emporium Ltd.* 87 A.T.C. 4363.

<sup>14</sup>[1969] N.Z.L.R. 1010 at p. 1018.

<sup>15</sup>(1958) 98 C.L.R. 460.

<sup>16</sup>*Ibid.*, p. 475.

the oil company were income. Of this contention *Williams J.* said:<sup>17</sup>

In other words (it was contended that) they formed part of the receipts of the business of the proprietor of a service station which the appellant was carrying on and were of the same character as the profits derived from the sale of the Shell products. The definition of income from personal exertion in the Assessment Act includes 'the profits of any business carried on by the taxpayer', *but these proceeds would only include receipts which have the character of income according to ordinary usages and concepts* except where the Act states or indicates an intention to the contrary...

After discussing further that decision and the Australian and New Zealand tax statutes *Turner J.* concluded the question will be the same in New Zealand as in Australia:<sup>18</sup>

Is the receipt income or capital? If it is gains or profits from a business, then the question reduces itself to whether these were derived from the *current* operations of the business, and therefore income, or whether no more can be contended, as regard their connection with the business, than that without the existence of the business they would not have accrued. If no more than this last can be proved, the gains cannot be assessable income, and simply because they are not derived from the current operations of the business. (emphasis added)

On the basis of *Turner J.*'s statements it is arguable that a lease incentive will generally not be assessable under the present section 88 equivalent, section 65(2)(a), because that profit or gain is not "derived from the *current* operations of the [lessee's] business". Rather the incentives' connection with the lessee's business is no more than "without the existence of the business" the incentive would not have been paid. The incentive may instead be an accretion to the capital assets of the lessee as the result of the lessee carrying on business.

In support of this the receipt of a lease incentive will, on the words of *Dixon C.J.* in *Dickenson v. F.C. of T.*, generally:

- (a) not be recurrent;
- (b) not be a normal or actual incident of carrying on the business of the taxpayer; and
- (c) not represent a purpose for which such a business is carried on.

Counsel for the Commissioner stated that the destination of a payment can

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<sup>17</sup>*Ibid.*, p. 482.

<sup>18</sup>[1969] N.Z.L.R. 1010 at p. 1019.

never be decisive of whether the payment is income or capital. Rather the origin of the payment must decide the matter. *Turner J.* did not consider it necessary to consider the submission suffice to say it seemed to him in most cases Counsel may be right. His Honour preferred to reserve for the time being the question whether in some cases the destination may have some bearing in deciding upon origin.

In the case before him:<sup>19</sup>

...all that is necessary to say is that when regard is had to the origin of the payments in the case before us it clearly appears that they do not stem from the current operations of the taxpayer's business. They are therefore not to be regarded as assessable income. This conclusion, on the facts in this particular case, does not follow from the fact that the payments were to be applied to a capital destination; it follows from the fact that they did not have their origin in current business operations.

For these reasons he believed the appeal in the *Napier Motors'* case must fail.

There was little to say in the appeal in the *City Motor's* case once the *Napier Motors'* appeal was disposed of in the taxpayer's favour. The only difference in the cases favoured the taxpayer in the *City Motor's* case. Had the *Napier Motors'* appeal been allowed, the taxpayer in *City Motors* may have had an argument based on the difficulty in deciding whether the increase in the premises value, the "gain" in that case, had yet been derived by the taxpayer. A further possible difficulty would have been the question of quantification, his Honour said. However it was not necessary to consider these arguments in the light of what was said in the *Napier Motors'* case. The *City Motor's* appeal was therefore also dismissed.

(5) *McCarthy J.*

His Honour looked first at the *City Motor's* case. The case raised the almost perpetual question whether an item of expenditure or receipt is of an income or capital nature.

Nothing turned on any difference between the language of section 88(a) and the comparable English and Australian legislation. The terms "income" or "capital" he said were not defined, accordingly it was to the decided cases one must turn.

*McCarthy J.* to this end began with the observation of Lord *Macmillan* in

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<sup>19</sup>Ibid., p. 1020.

*Van den Berghs Ltd. v. Clark*:<sup>20</sup>

While each case is found to turn upon its own facts, and no infallible criterion emerges, nevertheless the decisions are useful as illustrations and as affording indications of the kind of considerations which may relevantly be borne in mind in approaching the problem.

*McCarthy J.* also referred to Lord *Pearce* in the Privy Council in *B.P. Australia Ltd. v. Commr of Taxation of the Commonwealth of Australia* who commented that:<sup>21</sup>

The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a common-sense appreciation of all the guiding features which must provide the ultimate answer...

When his Honour looked at the case broadly and unaided by the reported decisions, he believed a normal businessman would have difficulty in viewing the expenditure otherwise than as capital expenditure, mainly because it was directed to improving the capital asset of the taxpayer.

Counsel for the Commissioner argued the decided cases compelled a contrary view. *McCarthy J.* turned to those submissions. I discuss only those submissions of relevance to this paper. It was submitted for the Commissioner:

(a) The method a profit or gain is applied is irrelevant to the question of whether it was income or capital.

The cases cited for the Commissioner,<sup>22</sup> *McCarthy J.* said decided:<sup>23</sup>

...that if money is received in circumstances which would normally make it income, and if later it is diverted by the taxpayer to capital purposes, that diversion does not change the character of the receipt so as to make the gain a capital one. But, all the same, the terms on which, or the purposes for which, money's are received can be of considerable importance in determining whether they are to be treated as capital or income in the hands of the recipient.

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<sup>20</sup>[1935] All E.R. 874.

<sup>21</sup>[1966] A.C. 224 at p. 264.

<sup>22</sup>*Parker v. Chapman* (1928) 13 T.C. 677, *Blake v. Imperial Brazilian Railway* (1884) 2 T.C. 58, and *Mersey Docks and Harbour Board v. Lucas* (1883) 2 T.C. 25.

<sup>23</sup>[1969] N.Z.L.R. 1010 at p. 1023.

*McCarthy J.* discussed the three cases cited by Counsel for the Commissioner and concluded that they were not authority for the proposition of Counsel. There was however on the other hand "a wealth of authority that in appropriate circumstances the terms on which moneys are to be received can be regarded as an important feature."<sup>24</sup>

In this regard *McCarthy J.* referred to three other cases that Counsel for the Commissioner had referred to: *Commissioner of Inland Revenue v. Coia*,<sup>25</sup> *McLaren v. Needham*,<sup>26</sup> and *Saunders v. Dixon*,<sup>27</sup> (the *Coia* line of cases) and also *B.P. Australia*.

(b) The authorities (apart from the *Coia* line of cases) show that profits or gains are of a revenue nature unless the taxpayer has in exchange parted with, surrendered or sterilised the use of an asset which is of a capital nature. Counsel cited four cases in support of this submission.<sup>28</sup>

*McCarthy J.* stated that none of these cases presented in any way a situation comparable with that before him.

Each case was an example:

(i) where money was received by the taxpayer in circumstances which may be thought would indicate that the moneys were income in the hands of the recipient and,

(ii) where to answer this it was sought to show that in return for the money received there was the surrender or exchange by the taxpayer of some asset of a capital nature.

Whenever this has been established the courts have held the moneys received be treated as replacing the asset that had been surrendered or sterilised and

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<sup>24</sup>*Ibid.*, p. 1024.

<sup>25</sup>(1959) 38 T.C. 334.

<sup>26</sup>(1960) 39 T.C. 37.

<sup>27</sup>(1962) 40 T.C. 329.

<sup>28</sup>*Dickenson v. F.C. of T.* (1958) 98 C.L.R. 460, *Van den Berghs Ltd. v. Clark* [1935] All E.R. 874, *Higgs v. Olivier* [1952] 1 Ch 311, and *Burmah Steam Ship Co. Ltd. v. Commissioner of Inland Revenue* (1930) 16 T.C. 67.

therefore capital.

His Honour reviewed the facts of the four cases. They did not establish that only where the taxpayer had parted with, or surrendered or sterilised a capital asset could a payment received by the taxpayer be seen to be a capital profit. The case before his Honour was of a different character altogether and the test to be applied was not that used in the line of cases to which Counsel for the Commissioner relied.

(c) The fact the payments were non-recurring was a neutral factor in the *City Motor's* case. *McCarthy J.* accepted this and continued whether non-recurrence is an important feature will always depend on the circumstances of the case. "The once-and-for-all character of the payment is not a feature on which I would place any weight in this particular case".<sup>29</sup>

(d) The fact that a payment is voluntary is not an indication that it is a capital gain in the recipient's hands. *McCarthy J.* commented, while it was true that the voluntary nature of a payment was not conclusive either way, and in some circumstances may be no indication of the character of a payment, that was not necessarily so. Once again it depends on the facts of the case. In the case before him, the fact the wholesaler offered to do the work without the retailer's request, was "at least a feature of the general background" and to that extent was far from being unimportant.

*McCarthy J.* reached the same conclusion as *Henry J.* *McCarthy J.* stated when it is recalled that sums of money were spent on the improvement of a capital asset of the taxpayer; that the taxpayer concerned did not request the improvements but rather acquiesced in what the wholesaler wished to do; that the only effect the work had in the company's books could possibly have been a writing up of the capital assets and that not until those assets were realised would there be any actual cash flow for the taxpayer, "one sees a picture of strong capital characteristics." Against this was only the feature stressed by Counsel for the Commissioner, "no surrender or sterilisation of a capital asset". For the reasons given his Honour did not think that feature important in the present class of case. Accordingly he upheld *Henry J.'s*

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<sup>29</sup>[1969] N.Z.L.R. 1010 at p. 1026.



finding and dismissed the appeal.

He turned to the *Napier Motors'* case. While there were distinct differences in the facts (one being that payments were made directly to the taxpayer), the principles to be applied were common to both cases.

Applying the principles already stated, his Honour saw the dominant features in the case to be that the purpose of the payment was the improvement of a capital asset; B.P.'s motive was the enlargement of its own trading profits; nothing was made available for distribution among the shareholders of the taxpayer for that could only come when the asset was realised; "...the taxpayer did not demand or even request the contribution as the price of its continuing to trade with...[B.P.], but rather accepted what was an entirely voluntary contribution...";<sup>30</sup> and that the taxpayer would not have been able to continue to sell petrol at the particular premises if help had not come from B.P.

When full weight was given to these factors, while not as clear as the *City Motor's* case, on balance he agreed with *Henry J.* that the payment ought to be treated as a capital receipt not an income receipt.

His Honour as a postscript sounded a word of warning, such an arrangement could be a disguise for what was actually an augmenting of the taxpayer's income. All such arrangements therefore called for careful scrutiny. *Henry J.* was aware of this and satisfied himself that there were no such implications.

#### (6) Conclusion

In each case their Honours held the payments made were not profits or gains derived from the taxpayer's business and were not to be regarded in the hands of the taxpayers as income.

The cases clearly discuss and distinguish between receipts which are capital and those which are revenue. *Turner J.*'s discussion on the meaning of "from the business" in terms of section 88(a) of the Land and Income Tax Act 1954 is important in applying the successor to section 88(a), section 65(2)(a) of the Income Tax Act 1976.

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<sup>30</sup>*Ibid.*, p. 1028.

On the basis of Mr Justice *Turner's* statements it could be argued that a lease incentive received by a lessee will not be assessable under section 65(2)(a) as it is not derived from the current operations of the lessee's business.

Some indication of the difference between the thinking in New Zealand and Australian judicial circles is evident in respect of *Boyce's* case. In the present case *North P.* quoted from the judgment of *Romer L.J.* with approval. In Australia in *G.P. International Pipecoaters Pty. Ltd. v. F.C. of T.* a decision given some 20 years after *City Motor's* their Honours believed the decision in *Boyce* was not sound in principle and should not in their opinion be followed in Australia.

2. *JOHN ANDERSON LTD. v. C. of I.R.*<sup>1</sup>

(1) Introduction

This recent High Court case concerned whether proceeds from the sale of a leased asset which were in excess of its residual value were derived from the business of the taxpayer and therefore assessable income. The decision also looked at whether the receipt was income according to general principles. The case was an appeal from a decision of the Taxation Review Authority and was heard by *Henry J.*

It has been suggested that there is a clear similarity between the case and the decision in *F.C. of T. v. Cooling*<sup>2</sup> and therefore the New Zealand courts may take a similar view to that taken in *Cooling* in respect of a lease inducement payment.

(2) The Facts

In 1973 the appellant entered into a leasing agreement with Marac Finance Ltd. (Marac) for the lease of a Kenworth truck and accessories. The appellant carried on the business as a transport operator. The vehicle was used in connection with and for the appellant's business. The appellant was not in the business of buying and selling motor vehicles.

The vehicle was sold in the 1978 income year by Marac for the sum of \$70,000. The residual value as determined in the leasing agreement was \$15,500. The appellant detailed the balance of \$54,500 as capital profit for the year ended 31 March 1978. The Inland Revenue Department considered the gain of \$54,500 was business income under section 65(2)(a) or (l) of the Income Tax Act 1976.

*Henry J.* summarised the issue as being whether the sum of \$54,500, which was the excess received on the sale of the vehicle over and above its residual value under the lease agreement, should be treated as a gain of capital or income.

(3) The Document

In considering this issue the relevant clauses of the lease agreement were

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<sup>1</sup>(1985) 7 N.Z.T.C. 5029.

<sup>2</sup>*F.C. of T. v Cooling* 90 A.T.C. 4472.

important. Under the terms of the lease agreement fixed instalments of rental were to be paid. On the termination of the lease Marac had an express obligation to sell the vehicle. The appellant was prohibited from obtaining title to the vehicle either before or after the termination of the lease. The appellant had only possessory and not proprietary rights. When the vehicle was sold, the agreement provided the appellant would pay Marac any shortfall between sale price and the stated residual value. Conversely any excess over residual value was to be paid to the appellant by Marac.

The agreement clearly detailed the respective rights and obligations of the parties. In particular, the total cost of leasing was clearly stipulated in monetary terms.

#### (4) The Nature of the Enquiry

He cited *Richardson J.* in *C. of I.R. v. Smythe*<sup>3</sup> who stated:

The first step in deciding the character in law of the lump sum payment in question is to determine the true nature of the legal arrangements pursuant to which the payment was made. It is that legal character of the transaction which is decisive - not the overall economic consequences to the parties, and not the legal consequences of an alternative transaction into which the taxpayer could have entered but chose not to do so.

*Richardson J.* in that passage also stated that the true nature of the transaction could only be ascertained by careful consideration of the legal arrangements that the parties actually entered into and performed. Consideration of the contract as a whole with regard to the surrounding circumstances was required. "The true nature of the transaction was not necessarily determined by the nomenclature used by the parties."

*Henry J.* noted that the leasing of plant and machinery was both a new phenomenon and one increasing in popularity. Lease incentives have also been popular due to the oversupply of commercial premises. A central point to *Hill J.*'s reasoning in *Cooling* was that in Queensland at that time the receipt of a lease incentive was an ordinary incident of leasing new premises of a substantial size.

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<sup>3</sup>(1981) 5 N.Z.T.C. 61,038 at p. 61,040.

(5) Income from the Business?

The taxpayer submitted the "profit" or "gain" was not derived from the transport operating business. His Honour cited a passage from the judgment of *Turner J.* in *C. of I.R. v. City Motor Service Ltd.; C. of I.R. v. Napier Motors Ltd.*<sup>4</sup> including: "I conclude without difficulty that the words 'from any business' in an Income Tax Act must mean 'from the current operations of any business' and no more".

On the basis of the *City Motor's* case and other cases referred to, it was submitted that the receipt was not derived from the business of the appellant as a transport operator.

Mr Justice *Henry* believed there were two answers to that submission.

First those, and other cases exemplifying the same principle, are all concerned with an asset which is owned by a taxpayer which has acquired an increase in value. Here there is no such asset; appellant never did own the vehicle, and by the very terms of the agreement never could own it at the relevant point of time...The cases are therefore clearly distinguishable. Second, in my judgment the receipt was an incident of carrying on the business, and was derived from the current operations. Those operations included the leasing of a vehicle as well as the use of it, and the leasing was incidental in a real way to the business of transporting goods.<sup>5</sup>

The receipt was therefore "derived from the appellant's business within the meaning of section 65(2)(a)."<sup>6</sup>

(6) Capital or Income?

*Henry J.* also considered whether the receipt was to be classed as an income receipt and not as a capital receipt. One of the Commissioner's submissions was that the payment was a revenue receipt according to ordinary concepts.

His Honour held the payment was also of an income nature. *F.C. of T. v.*

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<sup>4</sup>[1969] N.Z.L.R. 1010 at p. 1018.

<sup>5</sup>(1985) 7 N.Z.T.C. 5029 at pp. 5032-5033.

<sup>6</sup>*Ibid.*, p. 5033.

*Reynolds*<sup>7</sup> which concerned a road hauler who leased vehicles was cited by *Henry J.* as providing some assistance for his finding. In concluding that the payment fell on the "income" side of the dividing line according to ordinary concepts, *Henry J.* commented that each case must be determined in the light of its own facts. The origin of the payment in this case was in the contractual obligation undertaken by Marac, specifically to pay a sum equating to the excess over residual value of the vehicle's realisation on sale. The obligation to pay and the resulting receipt arose out of the business relationship the taxpayer had with Marac, Marac was the supplier and the taxpayer the user of plant in the course of and as a direct incidence of the operation of the taxpayer's transport business.

(7) Conclusion

(a) His Honour found the receipt of money was an incident of carrying on the business of a transport operator. The money was derived from the taxpayer's current operations which included the leasing and use of a vehicle. The leasing was incidental in a real way to the taxpayer's business of transportation of goods. Accordingly the money was derived from the taxpayer's business within the meaning of section 65(2)(a).

In addition the payment fell on the "income" side of the dividing line between income and capital. It did not come from any asset that belonged to the taxpayer but originated from a contractual obligation between the taxpayer and Marac.

(b) The case is important in respect of the taxation of lease incentives for several reasons:

(i) Cases such as *City Motors* were distinguished because they concerned an asset owned by the taxpayer. In the case of a lease incentive, the payment is obviously made in respect of an agreement to lease and not in respect of an asset owned by the lessee.

(ii) When discussing whether the payment was income, his Honour commented "Different considerations obviously apply where the taxpayer acquires

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<sup>7</sup>81 A.T.C. 4131.

the asset which then forms part of his capital structure"<sup>8</sup> from where assets are leased.

(iii) He held the operations of the taxpayer included the leasing of the vehicle as well as its use. Could it be argued in therefore respect of the lease of premises, that the lease is part of the operations of the taxpayer?

(iv) Could it also be argued on the basis of *John Anderson* that a lease incentive is not derived from an asset belonging to the lessee but from a contractual obligation between lessor and lessee?

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<sup>8</sup>(1985) 7 N.Z.T.C. 5029 at p. 5034.

3. *STATE INSURANCE OFFICE v. C. of I.R.*<sup>1</sup>

(1) Introduction

This case is important both in terms of the discussion of the capital and revenue distinction but also the discussion of *Californian Copper Syndicate v. Harris*<sup>2</sup> which, along with cases after it, played a significant part in the decision of the High Court in *F.C. of T. v The Myer Emporium Ltd.*<sup>3</sup>

(2) The Facts

The taxpayer, the State Insurance Office ["State"] was a state-owned fire and general insurer. It was not involved in the business of life insurance. It had built up large reserves including holdings of shares in listed companies. The reserves were held by State so it could recommence business if claims from a major calamity eliminated its working capital. In its 87-year history State had not been required to use those reserves.

In the income years ended December 1981 to 1985, State exchanged a small proportion of their shares in various public companies for other shares, following compulsory acquisitions as a result of company takeovers. In cases where the value of the shares received was in excess of the cost to State of those shares exchanged and the exchange consisted partly of payments in cash, the cash portion was returned as income.

The Commissioner issued amended assessments in respect of all share exchange profits. State objected to the assessments and claimed that its earlier concession of a taxable profit or gain was wrongly made. In the 1987 income year State claimed a deduction for a write-down of unrealised losses on its share investments, claiming, for the first time, that these investments were "trading stock" in view of the Commissioner's earlier assessment.

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<sup>1</sup>(1990) 12 N.Z.T.C. 7035.

<sup>2</sup>(1904) 5 T.C. 159.

<sup>3</sup>87 A.T.C. 4363.



The taxpayer submitted:

(a) On the facts, the gains on their share realisations were not income in the ordinary course of its business.

(b) Its business was managed to ensure that it was not necessary to liquidate its reserves. The reserves were not used to meet trading liabilities and were accounted for separately from trading income. Furthermore, the management of its investments was not motivated by consideration of its cash flow or the demands of its trading business.

The Commissioner submitted as insurance is a business of a special nature, profits on the realisation of shares were income according to ordinary concepts. While in the case of State the shares were held for long term, they were available for the calamity planning that formed part of any general insurance business.

The High Court gave judgment for State.

### (3) The Decision

In reaching its decision the Court stated there were two lines of authority to which it needed to resort in the case. The first, those cases which dealt with the general situation where a taxpayer who was engaged in a business, held shares or other investments and realised a gain or gains on these investments. And secondly there were the "banking and insurance" cases. In these cases the special circumstances of the business carried on by bankers and insurers often required that the sale or realisation of investments was in the circumstances, income.

*Heron J.* began by citing the dictum in the *Californian Copper* case, including the well known passage of Lord *MacDonald* concerning whether a gain is "...a mere enhancement of value by realising a security, or is it a gain made in an operation of business and carrying out a scheme for profit making?" In Lord *MacDonald's* opinion the company, *Californian Copper* was formed for the purpose inter alia of acquiring and reselling land:<sup>4</sup>

...I feel compelled to hold that this company was in its inception a company

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<sup>4</sup>(1904) 5 T.C. 159.

endeavouring to make profit by a trade or business and that the profitable sale of its property was not truly a substitution of one form of investment for another. It is manifest that it never did intend to work this mineral field with the capital at its disposal. Such a thing was quite impossible. Its purpose was to exploit the field, and obtain gain by inducing others to take it up on such terms as would bring substantial gain to themselves. This was that the turning of investment to account was not to be merely incidental, it was... the essential feature of the business speculation being among the appointed means of the company's gains.

*Heron J.* also quoted Lord *Trayner* in that case who commented:<sup>5</sup>

This is not in my opinion the case of a company selling part of its property for a higher price than it had paid for it, including that price as part of its capital, nor a case of a company merely changing the investment of its capital to pecuniary advantage. My reading of the appellant company's articles of association along with the other statements in the case satisfy me that the sale on which the advantage was gained, in respect of which income tax was said to be payable, was a profit trading transaction, one within the company's powers under the articles and contemplated as well as authorised by their articles. I am satisfied that the appellant company was formed in order to acquire certain mineral fields or workings not to work the same themselves for the benefit of the company but solely with the view and purpose of reselling the same at a profit.

*Henry J.* noted that Lord *Trayner* had regard to the fact that all the company's share capital was taken up with the acquisition of the capital assets, very little remained to work the minerals and bring them to the market.

*Henry J.* continued by analysing various "banking and insurance" cases. For the purposes of this paper much of that discussion is not relevant. Included among the cases he cited was the Australian case *Ipec Insurance Ltd. v. F.C. of T.*<sup>6</sup> The case concerned a company that carried on the business of an insurance company which acquired shares in its early years in order to attract business and in its later years so it could enhance its profits. It was taxed on the gains made in respect of the sale of shares. In respect of the well-known passage from the *Californian Copper* case *Zelling J.* stated:<sup>7</sup>

In any event although those observations of the Lord Justice Clerk taken from the *Californian Copper* case have been frequently cited in judgments of the High Court [of Australia], the observations in question which are based on and related to the concept of 'adventure or concern in the nature of trade' in the British Act

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<sup>5</sup>*Ibid.*, p. 167.

<sup>6</sup>75 A.T.C. 4137.

<sup>7</sup>*Ibid.*, p. 4148.

of 1842 are becoming more difficult to relate to our concept of income in sec. 25 as it has been developed in successive decisions of the High Court. It may be necessary at some stage to re-examine the present relevance of the *Californian Copper* case to questions arising under sec. 25. (emphasis added)

However in *London Australia Investment Co. Ltd. v. F.C. of T.*<sup>8</sup> decided two years after *Ipec*, the *Californian Copper* decision was cited with approval. Gibbs J. stated, after considering *Californian Copper* and another case:

In all those decisions the test suggested in *Californian Copper Syndicate v Harris* was applied. That test is applicable to any business, and if the sale of the shares is an act done in what is truly the carrying on of an investment business the profits will be taxable just as they would have been if the business had been that of banking or insurance.

Before giving his decision *Heron J.* noted that State had done all it could by prudent reinsurance and substantial cash reserves to avoid inroads into its share investments being made. These investments were to provide capital for a new business in the event that claims eliminated all its circulating capital and even some of its fixed capital. It was claimed, on the probabilities, that any such inroads would "go no further, even on disasters of considerable magnitude and catastrophic proportions."

It was acknowledged in the circumstances of the case that the shares were fixed capital and played no part in the circulating capital of the firm.

*Heron J.* commented it was clear from "a review of all the cases in this area that the dividing line between capital gain and income is not distinct." The recent cases suggested "the importance of a nexus between the realisation of the investment and the carrying on of the business." State did not suggest that the carrying out of its business did not require it to continually hold substantial reserves in a variety of investments. However they said that the likelihood of those reserves being used to meet claims was now remote, those reserves had taken on the role of fixed capital and any dealings in them should be to "capital account".

*Heron J.* stated "in the end it is a matter of standing back and looking at the whole picture in context". The share transactions were sporadic isolated transactions in the history of part of the fixed capital of State's undertaking. There was a

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<sup>8</sup>77 A.T.C. 4398.

connection with the insurance business undertaken as dividend income earned by State became part of their cash flow. His Honour stated however:<sup>9</sup>

Whilst there is a nexus between the income generated by the shares and the operation of the business I have described, there is no nexus between the realisations which occurred here and the method of operation of the business. The level of available assets held in relation to possible claims, explained by the history of the office, makes such realisations much less relevant and not so much linked to the insurance undertaking being carried out than might otherwise be the case. They are not in their character revenue assets in the sense that their realisation is inherent in or incidental to the carrying on of the business. They had become structural assets accumulated for the purpose of continuing in business after catastrophic claims which would eliminate on the worst projection some proportion of circulating capital.

And further:<sup>10</sup>

These realisations generally produced no cash which fell into revenue or played any part in cash flow. There was a mere exchange of shares and in effect a variation of investment, even though a realisation may have occurred.

A company that was responsible to shareholders could be presumed to have a level of assets that bore a more commercial relationship to the extent of claims. However no such demands affected the ability of State to build up reserves. *Heron J.* explained the rationale behind the banking and insurance cases as being the common business requirement of investments to be regularly realised in order to conform to certain ratios or actuarial assessments thought necessary for the purposes of the insurance or banking business or otherwise to carry out the objects of the business.

In the present case the fact that investments were only realised after compulsory acquisitions indicated the absence of a need or desire to sell the securities and was consistent with State's expressed intention of holding investments for their return and not for sale at a profit in the future. *Heron J.* stated this fact must also eliminate any suggestion that the transactions were business motivated:<sup>11</sup>

That compulsory acquisition in itself distances the transaction from being regarded as an integral part of the insurance business. I add that the compulsory aspect of the realisation is not however decisive in any case.

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<sup>9</sup>(1990) 12 N.Z.T.C. 7035 at p. 7063.

<sup>10</sup>*Ibid.*, p. 7064.

<sup>11</sup>*Ibid.*, p. 7065.

The onus of proof is on the taxpayer and in my view he has tipped the scales in his favour. It will be seen from the conclusion I have reached that State's case is an unusual one brought about by quite unique considerations and as a result departing from the outcome of most of the banking and insurance cases. The dividing line between income and capital gains is hard to see, a criteria acknowledged to exist but not well defined. I think these transactions were in all respects to capital account.

*Heron J.* also discussed whether it was necessary for investments that were not available for realisations to meet claims to be segregated from available securities.

The second point for determination in the case was whether the gains made as a result of the share exchanges were realised. The discussion by the Court on this point is outside the scope of this paper.

(4) Conclusion

(a) The Court held:

(i) The share exchange transactions were sporadic and isolated. They concerned the fixed as opposed to circulating capital of State's undertaking.

(ii) While the dividend income of the shares had a nexus with the operation of State's business, there was no nexus between the share realisations and the method of operations of its business.

(iii) The reserve of which the shares were a part was a provision for rebuilding purposes not a provision against claims. Accordingly it not part of the carrying on or carrying out of a business.

(iv) The fact that shares were disposed of because of compulsory acquisition indicated the lack of a desire or need by the taxpayer to sell securities and was consistent with its stated intention of holding investments for their return and not for sale at a profit.

(b) In addition in the case:

(i) The Australian case of *Ipec Insurance Ltd. v. F.C. of T.* raised doubts about the applicability of the often quoted observations of the Lord Justice Clerk in *Californian Copper* on the grounds that they were "based on and related to the concept of 'adventure or concern in the nature of trade'" in the 1842 British Act. *Zelling J.* believed it could be necessary to re-examine at some stage the relevance of

*Californian Copper* to questions arising under section 25 of the Australian tax Act.

(ii) *London Australia* however, a case two years subsequent to *Ipec*., indicated the test in *Californian Copper* to be applicable to any business. Obviously the recent Australian cases discussed including *Myer* also believe *Californian Copper* is still relevant to questions arising under section 25.

(iii) *Heron J* stated:<sup>12</sup> "The recent cases suggest the importance of a *nexus* between the realisation of the investment and the carrying on of the business" and "...there is no nexus between the realisations which occurred here and the method of operation of the business."

Could this line of argument be raised by the recipient of a lease incentive? Generally, in the case of an incentive there will be no nexus between the incentive and the method of operation of the lessee's business. The only nexus is that the incentive is received as a result of the taxpayer being in business. It is not a receipt derived from the operation of the business.

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<sup>12</sup>*Ibid.*, p. 7063.

4. *C. of I.R. v. THOMAS BORTHWICK & SONS (AUSTRALASIA) LTD.*<sup>1</sup>

(1) Introduction

This is a recent decision of the Court of Appeal. While the decision is brief it is a nonetheless important discussing again the distinction between income and capital. As well as the Court of Appeal's decision several points from *Gallen J.*'s judgment in the High Court are worthy of note.

(2) The Facts

Thomas Borthwick owned freezing works situated at Belfast. The works were its only South Island works. The Canterbury Frozen Meat Company Ltd. ("C.F.M.") was involved in both the processing and marketing of meat produce, owning three freezing works in the Canterbury area, one being at Belfast.

Before 1972 Thomas Borthwick and C.F.M. undertook discussions with a view to co-ordinating their activities within the industry. C.F.M. wished to increase its Belfast plants killing potential and extend the processing associated with it. Thomas Borthwick wished to improve its overall cashflow and considered its energies could be better employed, at least in the South Island, in marketing rather than killing.

In October 1972 an agreement was executed by both companies. Thomas Borthwick agreed to sell its Belfast works to C.F.M. for the sum of \$2.0 million. C.F.M. agreed that Thomas Borthwick would be entitled to acquire, for marketing purposes, the stock C.F.M. had itself acquired for processing and marketing.

While the sale of the works and the marketing agreement were dealt with under separate headings in the heads of agreement and subsequently in separate agreements, *Gallen J.* in the High Court accepted that it was to be regarded as a global transaction.

The marketing agreement was reduced to the form of a deed at the end of 1972.

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<sup>1</sup>(1992) 14 N.Z.T.C. 9101.

In 1980 due to a number of changes, the deed was varied giving C.F.M. the right to market certain stock which it could not have marketed had the original deed remained in force. In return for the concession C.F.M. agreed to pay Thomas Borthwick the sum of \$2.25 million in cash. The sum was calculated on the basis of a discounted assessment of future profitability.

Thomas Borthwick claimed that sum was a capital receipt while the Commissioner maintained it was income.

(3) The High Court<sup>2</sup>

(a) *Gallen J.* quoted Lord *MacMillan* in *Van den Berghs Ltd. v. Clark*<sup>3</sup> who said: "while each case is found to turn upon its own facts..." nevertheless "the [previous] decisions are useful as illustrations".

(b) Counsel for the Crown submitted in the interests of certainty so taxpayers could order their affairs, the appropriate way to resolve the various decisions was to consider each case as one of categories. If a payment fell within one category, then that would resolve the nature of the payment.

*Gallen J.* did not accept such an approach as he believed it could lead to an injustice and perhaps in some cases to conclusions that had little contact with reality. Instead he cited the well known passage of Lord *Pearce* in *B.P. Australia Ltd. v. Commr of Taxation of the Commonwealth of Australia*<sup>4</sup> including "The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other."

(c) *Gallen J.* considered that the objector had released a part of its continuing business structure in return for compensation and accordingly the payment was a capital item. His Honour did not overlook the fact that the sum paid

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<sup>2</sup>*Thomas Borthwick & Sons (Australasia) Ltd. v. C. of I.R.* (1991) 13 N.Z.T.C. 8063.

<sup>3</sup>[1935] A.C. 431 at p. 438.

<sup>4</sup>[1966] A.C. 224 at p. 264.



was calculated on a discounted assessment of future profitability. He stated:<sup>5</sup>

That is to add a flavour of income but cannot be decisive. The value of a capital asset is not infrequently assessed in terms of its income producing capacity. Such a consideration was in agency cases not decisive, see per Lord *Fleming* in *Kelsall Parsons and Company v Commissioners of Inland Revenue* (1938) 21 T.C. 608 at p. 622.

(4) The Court of Appeal

The Commissioner appealed the decision of *Gallen J.* The appeal was heard before *Cooke P.*, *Richardson* and *McKay J.J.* The judgment of the Court was delivered by *Richardson J.*

At the outset *Richardson J.* acknowledged, as he had in *McKenzies* case,<sup>6</sup> the capital income field to be "an intellectual minefield in which the principles are elusive and analogies treacherous (*Tucker v. Granada Motorway Services Ltd.*)"<sup>7</sup>

As with *McKenzies'* case, where he also delivered the judgment, *Richardson J.* began his analysis by referring to the observations of Lord *Pearce* in *B.P. Australia*<sup>8</sup> which exemplified the "governing approach at least in New Zealand".

Counsel for both the Commissioner and Borthwicks reviewed a number of reported decisions in various jurisdictions. The Court however did not find it necessary to review these cases for two reasons. The first being that consideration of the cases brought out the crucial importance that the facts of the particular case be evaluated. Lord *Pearce* in *B.P. Australia* emphasised that a commonsense appreciation of all the guiding features must provide the ultimate answer. Conflicting considerations may produce a situation where the answer will turn on questions of emphasis and degree.

The second reason was that in the case in terms of principle, the critical consideration was whether on the facts the 1972 supply and marketing contract was "to be characterised as providing an advantage for the enduring benefit of

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<sup>5</sup>(1991) 13 N.Z.T.C. 8063 at p. 8068.

<sup>6</sup>*C. of I.R. v. McKenzies N.Z. Ltd.* (1988) 10 N.Z.T.C. 5233 at p. 5236.

<sup>7</sup>[1977] 3 All E.R. 865 at p. 869.

<sup>8</sup>*B.P. Australia Ltd. v. Commr of Taxation of the Commonwealth of Australia* [1966] A.C. 224.

Borthwicks' trade and as forming part of the structure of Borthwicks' marketing operations."<sup>9</sup>

Counsel for the Commissioner argued for a contract to be on capital account, the contract must go to the structure of the business. A contract could not be so regarded unless it affects the greater proportion of the business activity. It was argued that *Gallen J.* in the High Court had placed too much emphasis on the contract's duration and not enough on the limited impact the contract had on the business of Borthwicks as a whole.

*Richardson J.* sounded a note of caution at this point: "One danger in this branch of the law is to take felicitous phrases used to describe extreme cases at one or other end of the spectrum and seek to employ them to test where a less clear cut case falls."<sup>10</sup>

He illustrates this by way of an example from *Halsbury* which gives the tax implications of the cancellation of an agency contract at two extremes but not the implications in the intermediate situation.

His Honour turned to *Van den Berghs Ltd. v. Clark*, the leading case where a contract was held to be a structural asset. The case concerned two margarine manufacturers, one English and the other Dutch. They entered into a cartel arrangement in 1908. The arrangement was to continue until 1940. However in 1927 the arrangement was rescinded by agreement with the Dutch company paying 450,000 pounds as damages to the English company. It was held that the contract was structural. *Richardson J.* quoted an extract from the judgment of Lord *Macmillan* including:<sup>11</sup>

...the cancelled agreements related to the whole structure of the appellant's profit-making apparatus. They regulated the appellant's activities, defined what they might and might not do, and affected the whole conduct of their business...The agreements formed the fixed framework within which their circulating capital operated; they were not incidental to the working of their profit-making machine but were essential parts of the mechanism itself. They

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<sup>9</sup>(1992) 14 N.Z.T.C. 9101.

<sup>10</sup>*Ibid.*, p. 9104.

<sup>11</sup>[1935] A.C. 431 at p. 442.443.

provided the means of making profits, but they themselves did not yield profits. The profits of the appellants arose from manufacturing and dealing in margarine.

The question of whether a supply and agency contract is structural or revenue *Richardson J.* said turned on the nature and significance of that contract in the business's operations.

In respect of the significance of the duration of the contract, *Richardson J.* quoted Lord *Pearce* in the *B.P. Australia* case:<sup>12</sup> "Length of time, though theoretically not a deciding factor, does in practice shed a light on the nature of the advantage sought. The longer the duration of the agreements, the greater the indication that a structural solution was being sought."

His Honour turned to consider the facts before him.

Borthwicks obtained a long term source of supply of produce for its international market by entering into the contract in 1972. It relinquished its freezing works in Belfast, a capital asset, and obtained the supply of produce from the four Canterbury freezing works of C.F.M. without having to acquire the physical assets involved. In that way the agreement was the framework providing the means of making profits from the stock that was raised and processed in Canterbury. The supply agreement was overall of major significance for Borthwicks' business operations, leading to a 40% increase in their share of the New Zealand lamb kill. The payment by C.F.M. of \$2.25 million for the surrender of some 20% of Borthwicks' supply rights was an indication of the value and importance the supply contract was to the business. "This semi-permanent supply contract was of fundamental significance to Borthwicks' marketing operations."<sup>13</sup> The supply contract's omission from the balance sheet was not surprising and in the circumstances could not affect its true character given that no specific sum had been allocated in the heads of agreement to it.

He concluded that their Honours were satisfied that the contract was a capital asset of Borthwicks. The \$2.25 million was received on capital account.

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<sup>12</sup>[1966] A.C. 224 at p. 267.

<sup>13</sup>(1992) 14 N.Z.T.C. 9101.

(5) Conclusion

(a) The Court of Appeal held the payment was received on capital account. The supply and marketing contract was a capital asset because it formed part of the business structure of Borthwicks. "The semi-permanent supply contract was of fundamental significance to Borthwicks' marketing operations". The payment of \$2.25 million for the surrender of 20% of Borthwicks' supply rights was an indication of the value and importance of the supply contract to Borthwicks.

(b) Comments on the decision.

(i) Despite the large sum involved the judgment is relatively brief. This can be explained in part by the more lengthy judgment given by Mr Justice *Gallen* in the High Court, to which the Court of Appeal concurred. In addition the application of the principles from previous authorities was relatively straightforward. As one might expect, the Court's approach mirrored that of its earlier decision in *McKenzies'* case.

(ii) The judgment follows the traditional line of authorities that discuss the income capital distinction, such as *B.P. Australia* and *Van den Berghs Ltd. v. Clark*.

(iii) If the business structure approach adopted in *Thomas Borthwick* is applied to the receipt of a lease incentive, a lease (of premises) will usually form part of the framework which enables the lessee to derive assessable income from the activities carried on in the leased premises. Any incentive will therefore be capital in nature.

(iv) There is no mention of the recent line of Australian decisions including *F.C. of T. v. The Myer Emporium Ltd.*<sup>14</sup> The approach of the Court, it is suggested in the *New Zealand Master Tax Guide*:<sup>15</sup> "amounted to an implicit rejection of the approach taken in" *Myer and Cooling*.<sup>16</sup>

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<sup>14</sup>87 A.T.C. 4363.

<sup>15</sup>*New Zealand Master Tax Guide*, (1993) C.C.H. New Zealand Ltd, p. 370.

<sup>16</sup>*F.C. of T. v. Cooling* 90 A.T.C. 4472.

5. *C. of I.R. v. INGLIS*<sup>1</sup>

(1) Introduction

This Court of Appeal decision concerns the deductibility of losses on the sale of shares and is a companion case to *C. of I.R. v. Stockwell*<sup>2</sup> which concerned the same issue, the judgments being handed down on the same day.

As already mentioned in *Stockwell* their Honours discussed when a business of share trading existed. In *Inglis*, their Honours discussed the distinction between capital and revenue, the case revolved around sections 65(2)(e) and 106(1)(a) of the Act.

(2) Background

The taxpayer was a management consultant employed by an international accountancy firm. During 1986 and 1987 he invested some money in the sharemarket, being part of the proceeds of two house sales.

All his shares were sold in December 1987 at a loss of \$47,749 which he claimed in his 1988 return of income. The taxpayer maintained his motive in acquiring the shares was to fund the purchase of a home. He purchased the shares which he hoped would appreciate in value quickly. The resale of the shares at a profit was his consistent purpose.

The Commissioner disallowed the deduction. The Commissioner did not dispute that any profits on the resale of particular parcels of shares would have been taxable under the second limb of section 65(2)(e). The Commissioner contended that any profits or losses that were in fact incurred were nevertheless capital profits or losses. On the Commissioner's approach section 106(1)(a) would override section 104 in the event of a loss, the investment had been of capital and the loss was part of that capital.

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<sup>1</sup>(1992) 14 N.Z.T.C. 9180.

<sup>2</sup>(1992) 14 N.Z.T.C. 9190.

(3) The Decision

The important points can be summarised as follows:

(a) The share activities lacked sufficient continuity and extent to justify a description as a business.

(b) *Cooke P.* commented:<sup>3</sup>

...that the decision on whether expenditure should be classified as of capital or as a revenue item must ultimately be a matter of common sense in the particular circumstances and is not governed by any single consideration or precise rules.

(c) The word "capital" in section 106(1)(a) bears its ordinary and natural meaning. In some cases there are two natural and ordinary meanings between which a choice has to be made. These are cases where a distinction is available between fixed capital and circulating capital.

In many cases there is no possibility to classify an item as circulating capital. For cases where there is the possibility, it is necessary to determine which of the two meanings in section 106(1)(a) the Legislature intended. *Cooke P.* stated there could hardly be any doubt that fixed capital was what was meant.

(d) In the first limb of section 65(2)(e) the Legislature intended the cost of circulating capital to be deductible in calculating profits or gains derived by businesses dealing in personal property. The Legislature also intended that losses should be deductible from the total income of the taxpayer in accordance with section 104. *Cooke P.* concluded in order to make the Act work the same applied to the other limbs of section 65(2)(e):<sup>4</sup>

By bringing in the profits or gains the legislation, reading together sec 65(2)(e), 101, 104 and 106(1)(a), authorises the deduction of circulating capital, or in other words the cost of stock in trade, that has been expended or parted with. If the result is a loss it is deductible from the total income under sec 104. In a case such as the present, the taxpayer by buying shares for resale has in substance stamped their cost as circulating capital and the shares themselves as stock in trade. They have become held on revenue account.

This conclusion produces a symmetry between the taxability of gains and the deductibility of losses.

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<sup>3</sup>(1992) 14 N.Z.T.C. 9180 at p. 9185.

<sup>4</sup>*Ibid.*, p. 9186.

(e) Reference was made to the observations of Lord *Pearce* in *B.P. Australia Ltd. v. Commr of Taxation of the Commonwealth of Australia*<sup>5</sup> and the factors listed by *Richardson J.* in *C. of I.R. v. McKenzies N.Z. Ltd.*<sup>6</sup> that were weighed by the Judicial Committee in *B.P. Australia*. One of these factors was "whether the payments were made from fixed or circulating capital."

(f) *McKay J.* stated that the concept of fixed and circulating capital:<sup>7</sup>

...recognises the distinction between what is invested in revenue producing assets of an ongoing nature, and what is invested in goods which are traded or which are manufactured and sold...If a person was in the business of trading in shares, then his share portfolio would be his stock in trade, and his investment in shares would represent circulating capital.

(g) *McKay J.* concluded his judgment by stating:<sup>8</sup>

I think, therefore that by deeming the profits or gains of the share transactions to be assessable income sec 65(2)(e) has made the costs of purchase of the shares deductible. It has thereby changed the nature of that cost so that it is no longer capital but is of a revenue nature, and therefore outside the scope of sec 106(1)(a). Alternatively, it is within the exception of the introduction to sec 106(1), 'except as expressly provided by this Act'.

The Court held the losses were deductible.

#### (4) Conclusion

(a) The Court referred to the 'traditional line of cases in respect of the income - capital distinction, in particular the *B.P. Australia* and *McKenzies*' decisions. No reference was made to the *Myer*<sup>9</sup> and *Cooling*<sup>10</sup> decisions.

(b) There is discussion of the concept of circulating capital, a concept mentioned briefly in passing by *Richardson J.* in *McKenzies*' case:<sup>11</sup> "A lease will be

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<sup>5</sup>[1966] A.C. 224.

<sup>6</sup>(1988) 10 N.Z.T.C. 5233.

<sup>7</sup>(1992) 14 N.Z.T.C. 9180 at p. 9190.

<sup>8</sup>*Ibid.*, p. 9190.

<sup>9</sup>*F.C. of T. v. The Myer Emporium Ltd.* 87 A.T.C. 4363.

<sup>10</sup>*F.C. of T. v. Cooling* 90 A.T.C. 4472.

<sup>11</sup>(1988) 10 N.Z.T.C. 5233 at p. 5237.

held on revenue account if the taxpayer trades in leases so that the leases form part of its trading stock or are otherwise regarded as circulating capital".



6. A TERMINATION PAYMENT: *C. of I.R. v. McKENZIES N.Z. LTD.*<sup>1</sup>

(1) Introduction

As stated in the introduction to this section no cases have been directly decided on the assessability of lease incentives. Some indication of the likely approach of the Taxation Review Authority and courts to this issue may be gauged by looking at the manner in which the antithesis of a lease incentive, a payment to terminate a lease obligation has been examined by the New Zealand Court of Appeal in *C. of I.R. v. McKenzies N.Z. Ltd.*

(2) The Facts

McKenzies had retail stores in cities and larger towns in New Zealand. These stores were serviced from warehouses operated by McKenzies. McKenzies owned some of these premises. The balance were leased. In 1968 they entered into a fifty year lease of warehouse premises in Mount Wellington, Auckland. The rent which was subject to five yearly reviews commencing on 1 July 1978, was \$101,000 per annum. As well as rent, the lessee was liable for rates and insurance premiums.

By 1979 the warehouse was no longer required by McKenzies for its retail business. The property was sublet for a two year term that expired on 31 December 1980. In early 1980 McKenzies became a wholly owned subsidiary of L.D. Nathan & Co. Ltd. After the takeover McKenzies ceased retailing. Thereafter its business was comprised solely of managing its freehold and leasehold properties and other investments. It had thirty two properties which it leased out.

McKenzies surrendered two leases. It received \$205,000 on the surrender of a long term lease of warehouse premises in another part of Auckland. Inland Revenue Department approval was received for treating that sum in the accounts as a capital receipt.

The company negotiated with the lessor Challenge Corporation Ltd. for release from the lease of the Mount Wellington property in consideration for the

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<sup>1</sup>(1988) 10 N.Z.T.C. 5233.

payment of a lump sum. The company secretary advised the Commissioner of Inland Revenue in a letter in 1987 that this was done "as part of the rationalisation of putting the businesses of Woolworths [also owned by LD Nathan & Co.], McKenzies and LD Nathan's together". In his evidence however, he said while that was a reason for seeking the termination of the lease:<sup>2</sup>

...the principal reason was to rid the objector of a lease it regarded as onerous principally because of the long term and because of a concern that when the Fisher & Paykel lease terminated [at 31 December 1980] the objector would have difficulty in the current economic climate of finding an alternative tenant prepared to pay a rent equal to the rent to which the objector was liable under the lease.

In July 1980 Challenge Corporation offered by letter to surrender the lease on payment of \$250,000. The letter was accompanied with detailed calculations of the present values of the rent and various other commitments of the lessee under the lease. The \$250,000 itself was not a simple computation of a certain number of years' payments under the lease. Other factors were also referred to. There was no evidence that the \$250,000 had any direct relation to recurrent expenses. Rather in the letter Challenge believed after considering all the aspects involved that the sum would be a fair and reasonable amount to rescind the lease.

Discussions followed. McKenzies wrote to Challenge and offered \$180,000 without calculations. They finally agreed to the payment of \$190,000. The sum was duly paid and the lease released by Deed of Surrender on 9 January 1981.

In its accounts for the financial year ended 31 August 1981, the payment was described as "Premium paid to relinquish lease of property."

The Commissioner disallowed the deduction. In disallowing McKenzies objection the Commissioner relied on the general deductibility provision of the Income Tax Act 1976. The Commissioner also relied on Section 106(1)(a) which prohibits deductions for any "Investment, expenditure, loss or withdrawal of capital".

### (3) The High Court

At the hearing in the High Court the Commissioner did not advance any

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<sup>2</sup>Ibid., p. 5234.

argument under section 104. It was accepted by *Tompkins J.* that the expenditure was necessarily incurred by the taxpayer in carrying on a business for the purpose of gaining or producing assessable income within section 104(b).

In looking at section 106(1)(a) he found the issue to be evenly balanced. Specifically in support of the payment being regarded as capital:

(a) The lease was an identifiable capital asset.

(b) The company was in the business of leasing premises, not in the business of dealing in leases.

(c) The lump sum payment was made once and for all and resulted in an enduring benefit in the sense that McKenzies disposed of a lease that was uneconomic. This was accentuated by the unexpired portion of the lease being a further 38 years.

(d) It was arguable that in as much as the company was no longer sub-leasing the premises to a sub-tenant, to that extent McKenzies was going out of business. However it was also equally arguable that McKenzies remained in that business even though during the course of it, individual leases were acquired or disposed of.

There were indications that the payment should be regarded as having been paid on revenue account. Specifically:

(a) The payment was made to eliminate a future revenue liability [in the form of rent].

(b) There were two results of the payment:

(i) McKenzies disposed of the lease; and

(ii) It disposed of the onerous rental payments to which the company otherwise would have been liable.

(c) The payment was based on a calculation of rent payable in the future and not on some other capital basis.

The scales were tipped in favour of the taxpayer due to the character given to payments made in respect of leases under the scheme of the Income Tax Act. Under section 65(2)(g) and section 80 premiums derived by the owner of land from a lease

are treated as assessable income. Likewise section 137 allows a deduction for a premium paid on the grant or renewal of a lease.

His Honour concluded if a payment made to obtain the grant or renewal of a lease is treated as a revenue payment then, unless there are other persuasive factors in any particular case, a payment made for the purpose of terminating a lease should be so regarded. In this case there were no other persuasive factors present.

(4) The Court of Appeal

In delivering the judgment, *Richardson J.* dealt first with the provisions of the Income Tax Act dealing with the income tax treatment of receipts and payments in respect of other types of lease transactions. He then went on to discuss the relevant cases on the distinction between income and capital.

(a) The Income Tax Act. The provisions in the Income Tax Act referring to the tax treatment of receipts and payments from other kinds of lease transactions were "an insubstantial foundation from which to draw inferences as to the assessability or deductibility of payments in respect of the surrender of leases, one way or the other."<sup>3</sup>

All that could be concluded from the Act his Honour said was that:<sup>4</sup>

(i) Premiums derived from any lease of land by the owner are assessable income of the owner pursuant to section 65(2)(g).

(ii) The premiums can be apportioned by the Commissioner between that income year and up to five subsequent years (section 80).

(iii) Section 137 permits the deduction of a premium paid on the grant, renewal or acquisition of a lease and for such a deduction to be spread over the years that the land is used in income producing activities as if the amount of the premium were evenly apportioned over the term of the lease. The section treats a lease as a wasting asset. The premiums are treated as being used up over the term of the lease in the production of assessable income.

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<sup>3</sup>Ibid., p. 5235.

<sup>4</sup>Ibid., p. 5235.

The statutory provisions did not deal with the taxation of premiums paid or received on the surrender of a lease. His Honour commented it was not even as if they could be apportioned prospectively as in the case of premiums under section 80 and section 137. "In the circumstances it would be unsafe to draw any inference of a legislative purpose other than that their character as capital or income fall for determination on general taxation principles."

*Richardson J.* then focused on the "general taxation principles."

(b) The Distinction between Income and Capital. *Richardson J.* cited the observations of Lord *Pearce* in the Privy Council in *B.P. Australia Ltd. v. Commr of Taxation of the Commonwealth of Australia*<sup>5</sup> in respect of whether expenditure was capital or income.

Lord *Pearce*'s observations can be summarised as follows:

(i) "The solution to the problem is not to be found by any rigid test or description."

(ii) Any decision is derived from many aspects of the whole set of circumstances. Some circumstances may point in one direction, while others in another. There may be a consideration that points so clearly that it dominates other, more vague indications in the other direction.

(iii) "It is a commonsense appreciation of all the guiding features" that must provide the final answer.

(iv) In "obvious" cases the categories of income and capital expenditure are distinct and easily ascertainable. These are cases that lie far from the boundary. It is however the borderline cases where the line of distinction is often hard to draw:<sup>6</sup>

...and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:

'depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process.'

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<sup>5</sup>[1966] A.C. 224 at p. 264-265.

<sup>6</sup>*Ibid.*, pp. 264-265.

per Dixon J in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634,648.

(v) Felicitous phrases from earlier decisions are used when new cases are argued by both sides. Such phrases are not the deciding factor nor is their application unlimited. They merely crystallise certain factors that may incline the scale in a particular case after all considerations have been taken into account.

Lord *Pearce's* observations underline that there are borderline cases. In those cases deciding on which side of the line the item falls "a commonsense appreciation of all guiding features which must provide the ultimate answer."

The Judicial Committee in *B.P. Australia* weighed up a number of factors in considering the character of payments made by the taxpayer to secure exclusive sales outlets. The payments were held to be of a revenue nature.

*Richardson J.* noted some of the factors weighed in *B.P. Australia*:<sup>7</sup>

- (i) The need or occasion that called for the expenditure.
- (ii) "Whether the payments were made from fixed or circulating capital".

In *B.P. Australia* the Judicial Committee stated that this test is not always helpful or easy to apply or appropriate.

(iii) "Whether the payments were of a once and for all nature producing assets or advantages which were an enduring benefit;" This test is from *British Insulated and Helsby Cables Ltd. v. Atherton*.<sup>8</sup>

(iv) How would the payment be treated on ordinary principles of commercial accounting?

(v) Whether the payments were expended on the taxpayer's business structure or were part of the process by which the taxpayer earned income.

A number of these tests have been discussed in part A.

While this case and the companion Privy Council case of *Mobil Oil Australia Ltd. v. Commr of Taxation of the Commonwealth of Australia*<sup>9</sup> held the payments in

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<sup>7</sup>(1988) 10 N.Z.T.C. 5233 at p. 5236.

<sup>8</sup>[1926] A.C. 205.

<sup>9</sup>[1966] A.C. 275.

question were of a revenue nature, the House of Lords in a judgment delivered the same day in *Regent Oil Co. Ltd. v. Strick*<sup>10</sup> held payments by an oil company were capital.

*Richardson J.* through this comparison illustrated that it is important to evaluate the facts of each case and to recognise as *Templeman J.* in *Tucker v. Granada Motorway Services Ltd.*<sup>11</sup> had stated: "the capital income field is an intellectual minefield in which the principles are elusive and analogies are treacherous".

His Honour noted that the broad approach of the Privy Council in *B.P. Australia* had been recognised in New Zealand in *C. of I.R. v. L.D. Nathan & Co. Ltd.*<sup>12</sup> and *Buckley & Young Ltd. v. C. of I.R.*<sup>13</sup> *North P.* in *L.D. Nathan & Co. Ltd.* considered the character of the payments before him were clear enough not to require the tests enunciated in *B.P. Australia* to be applied. While in *Buckley & Young* it was not necessary, in the words of the Court:<sup>14</sup> "to enter any twilight areas in this case for it is common ground that the alternatives clearly fall on opposite sides of the dividing line and far from the boundary".

His Honour made no reference to the *Myer*<sup>15</sup> case. Rather he focused on the 'traditional' cases on the income-capital distinction.

(c) "The Decision in Principle". His Honour turned to review the facts to see if they pointed clearly to a particular conclusion, "rather than going directly to reported cases".

He considered the nature of the asset involved. *Tompkins J.* had found that the lease was a capital asset of the company. This was not challenged on appeal. As

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<sup>10</sup>[1966] A.C. 295.

<sup>11</sup>[1977] 3 All E.R. 865 at p. 869.

<sup>12</sup>[1972] N.Z.L.R. 209.

<sup>13</sup>(1978) 3 N.Z.T.C. 61,271.

<sup>14</sup>*Ibid.*, p. 61, 275.

<sup>15</sup>*F.C. of T. v. The Myer Emporium Ltd.* 87 A.T.C. 4363.

noted in earlier chapters, *Richardson J.* stated that a lease will be held on revenue account if the taxpayer trades in leases, so that the leases form part of the taxpayer's trading stock or are otherwise regarded as circulating capital. In this case however, the lease was part of the profit-making structure of the business.

This analysis follows the line in *B.P. Australia*. One of the factors weighed in that case in determining the nature of payments made by the taxpayer, was the character of the item on which the payments were expended.

*Richardson J.* stated it was not surprising the lease was not shown in the balance sheet. No sums had been paid for the lease on capital account and where accounts were prepared on an historical cost accounting basis there was no reason for the lease to be entered in the books on capital account at a zero value. The true character of the lease itself was not, in the circumstances, affected by the non-appearance of it in the balance sheet.

As noted, one of the factors weighed in *B.P. Australia* was how the payment would be treated on ordinary accounting principles. The Full High Court in *Myer* also drew support for its decision from the accounting basis used to calculate profits and losses for the purposes of the Australian Act.

*Richardson J.* continued, in what he called "an uncomplicated case" the characterisation of the asset that had been acquired or disposed of by the taxpayer would determine the character or quality to be attributed to the costs of acquisition or disposal. In effect he is saying that the quality or character to be attributed to the expenditure took its colour from the character of the asset to which it related.

He commented:<sup>16</sup>

Just as moneys spent on the acquisition of a capital asset are prima facie regarded as capital expenditure, so too the proceeds of the disposal of a capital asset or the costs of its disposal where it has a negative value should in the ordinary course have the same character.

His Honour concluded that if, as was the case before him, the lease was a capital item then, in "an uncomplicated case" where a lump sum payment was the cost to dispose of that capital item, the expenditure concerned should be regarded as

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<sup>16</sup>(1988) 10 N.Z.T.C. 5233 at p. 5237.



capital expenditure.

*Richardson J.* did not define what was "an uncomplicated case". However, in terms of Lord *Pearce's* observations in *B.P. Australia* perhaps he had in mind a situation where the facts fell clearly on either side of the capital-income line.

His Honour analysed the rights of the lessee. The interest of the lessee gave the lessee reciprocal rights and obligations. The lessee had the right to occupy the premises so leased. However, there was an obligation to perform the terms and conditions under the lease including the payment of rent to occupy the premises. When the lessee surrendered the lease, the lessee surrendered the whole of the interest under that lease. It was fallacious, according to *Richardson J.* to focus narrowly on the obligation to pay rent being extinguished without recognising at the same time that the lessee was also giving up the right to possess the property.

His Honour concluded:<sup>17</sup> "Unless there are other complicating factors present which lead to a different conclusion, a lump sum payment made in consideration of the surrender of a lease held on capital account ought to be regarded as an expenditure of capital".

(d) Special Considerations. Having established prima facie that the payment was of a capital nature his Honour examined whether there were any special considerations in support of or contrary to his initial finding.

In the case before him there was a Deed of Surrender. The Deed:<sup>18</sup>

...provided that in consideration of the surrender price the lessee surrendered and assigned to the lessor the premises comprised and demised in the memorandum of lease to the intent that the term of years thereby created might merge and be extinguished in the fee simple of the land.

Counsel for the taxpayer submitted that the payment made by McKenzies to Challenge amounted to a commutation of the future revenue obligations McKenzies would face had the lease continued. The surrender of the lease was merely an adjunct to that.

*Richardson J.* noted in respect of this submission:<sup>19</sup> "It must be accepted

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<sup>17</sup>*Ibid.*, p. 5237.

<sup>18</sup>*Ibid.*, p. 5237.

that where lump sum payments are made in substitution for future expenditures it may be difficult to determine whether they should be treated as income or capital." In a broad sense, he said, the value of an asset must equal the present discounted value of all its expected receipts less expenses, over the life of the asset.

The first question, *Richardson J.* said however, was whether the payment was to be regarded as a commutation payment at all. This was a matter of analysing the particular transaction. He stated:<sup>20</sup>

While it may not be appropriate to allow the intricacies of the law of property to dominate the interpretation and application of tax legislation where the objects, concepts and thrust may be quite different, it is well settled that the true nature of a transaction must be ascertained by reference to the legal arrangements actually entered into and carried out and taking into account surrounding circumstances, and the documents themselves may be brushed aside only if and to the extent that they are shams or the legislation itself so requires.(emphasis added)

As seen in the above quote *Richardson J.* placed great importance on the documents themselves. The documents could only be brushed aside if and to the extent they were shams or the legislation so required. In deciding the assessability of any lease incentive on the basis of *Richardson J.*'s statement, all documentation will be thoroughly scrutinised.

Turning to the Deed itself, *Richardson J.* stated:

- (i) There were 38 years remaining of the lease.
- (ii) The parties had entered into a standard form of surrender.
- (iii) When McKenzies surrendered the lease they relinquished the right of possession of those premises, a right which was a valuable right if viewed separately.
- (iv) McKenzies perceived the right of possession for the term of the lease to be worth less than the present value of the obligations under the lease.
- (v) The parties negotiated over "the global value of the interest under the lease". This was evidenced from the comparison between the agreed figure of \$190,000 and the present value calculations by Challenge of the obligations of

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<sup>19</sup>Ibid., p. 5237.

<sup>20</sup>Ibid., p. 5237.

McKenzies under the lease. The obligations for the first ten years remaining totalled \$637,712. The rent alone for the remaining 38 years amounted to \$843,861.

(vi) This was not a situation where the right to possession was worthless and (as evidenced by (v)) where the surrender price was expressed and calculated as being a simple commutation of all future payments to be made under the lease

*Richardson J.* noted there was no particular relation between the sum that was paid and the future deductible expenditure under the lease.

(vii) His Honour concluded his analysis of the Deed by stating:<sup>21</sup>

In short, the deed of surrender represented the true agreement between the parties and it was the surrender of the entire interest under the lease that was the subject of the payment made by McKenzies.

On this brief analysis the payment made by the company in consideration of the surrender of the lease ought in principle to be regarded as an expenditure of capital.

Thus the Deed supported his earlier preliminary findings.

(e) Case Law. After looking at the Deed of Surrender *Richardson J.* turned to the authorities.

In New Zealand there were no reported decisions concerning the deductibility of payments made on the surrender of a lease. In Australia, the Australian Income Tax Assessment Act 1936 dealt with this matter in section 85. *Richardson J.* noted the clear line of English authority.

There is now also the Australian decision *Kennedy Holdings and Property Management Pty. Ltd. v. F.C. of T.*<sup>22</sup> which concerned a lump sum payment made to a lessee by the lessor in consideration of the lessee vacating the premises. The payment was capital and not deductible.

(f) Case law: *Tucker v. Granada Motorway Services Ltd.* The leading English authority was *Tucker v. Granada Motorway Services Ltd.*<sup>23</sup> *Richardson J.* discussed the case in some detail.

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<sup>21</sup>*Ibid.*, p. 5238.

<sup>22</sup>92 A.T.C. 4918.

<sup>23</sup>[1979] 2 All E.R. 801.

The *Tucker* case concerned a lease, granted by the Minister of Transport to a company, of a motorway service area for 50 years. The rent consisted of two elements, a fixed rent and an additional rent consisting of a percentage of the previous year's gross takings derived from the provision of services. The gross takings included the amount of tobacco duty included in the price of the tobacco. As tobacco duty increased, the additional rent rose reducing the profitability of the service area.

Following negotiations, the Minister of Transport offered to exclude for the remaining term, the amount of the tobacco duty from the gross takings for the purpose of calculating the additional rent payable. In return the company agreed to pay a lump sum of 122,220 pounds being six times the amount of additional rent due on tobacco duty for the year ending 31 July 1973.

The company claimed a deduction for the payment being a payment to get rid of an annual charge against future revenue. This was similar to the reason for the termination payment put forward by the secretary of McKenzies. He stated the principle reason for the payment was to rid McKenzies of a lease it regarded as onerous due to the length of the term, and possible problems of letting the premises in the future for the figure it was currently let.

The payment in *Tucker* was held to be capital on the basis it was as a once and for all expenditure on the lease, which was an identifiable capital asset and was designed to make it more advantageous. This was the case even though the lease was non-assignable and therefore had no balance sheet value.

(i) In the decision their Honours emphasised the 'identifiable asset' test. Lord Wilberforce stated:<sup>24</sup>

It is common in cases which raise the question whether a payment is to be treated as a revenue or as a capital payment for indicia to point different ways. In the end the courts can do little better than form an opinion which way the balance lies.

There are a number of tests which have been stated in reported cases which it is useful to apply, but we have been warned more than once not to seek

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<sup>24</sup>Ibid., p. 804.

automatically to apply to one case words or formulae which have been found useful in another (see *Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd* [1964] AC 948). Nevertheless reported cases are the best tools that we have, even if they may sometimes be blunt instruments.

This echoes observations made by Lord *Pearce* in *B.P. Australia*.

Lord *Wilberforce* continued:<sup>25</sup>

I think that the key to the present case is to be found in those cases which have sought to identify an asset. In them it seems reasonably logical to start with the assumption that money spent on the acquisition of the asset should be regarded as capital expenditure. Extensions from this are, first, to regard money spent on getting rid of a disadvantageous asset as capital expenditure and, secondly, to regard money spent on improving the asset, or making it more advantageous, as capital expenditure. In the latter type of case it will have to be considered whether the expenditure has the result stated or whether it should be regarded as expenditure on maintenance or upkeep, and some cases may pose difficult problems.

(ii) Lord *Wilberforce* also referred to the well known statement of principle of Lord *Cave* in *British Insulated and Helsby Cables Ltd. v. Atherton*:<sup>26</sup>

When an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is a very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.

(iii) "...the sheet anchor of the appellants' argument", was the English case *Anglo-Persian Oil Co. Ltd. v. Dale (Inspector of Taxes)*.<sup>27</sup> In that case a payment was made to put an end to a long-term agency agreement through which the taxpayer had carried on its business in the Middle East and which had become onerous to the company. The payment was deductible.

Applying Lord *Cave*'s test to the payment in *Anglo-Persian Oil*, *Richardson J.* in *McKenzies* commented that it did not bring into existence any asset nor could it properly be said to have brought into existence an advantage for the benefit of the trade of the company within the meaning of Lord *Cave*'s expression.

*Richardson J.* also noted two points about that decision. Firstly, the distinction between fixed and circulating capital reflected in the case *Staveley Coal*

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<sup>25</sup>*Ibid.*, p. 804.

<sup>26</sup>[1926] A.C. 205 at p. 213-214.

<sup>27</sup>(1931) 16 T.C. 253 at p. 262.

*and Iron Co. Ltd.* was expressly recognised. The agency agreement in the *Anglo-Persian Oil Co.* case was held not to be a fixed capital asset of the company. Secondly, *Rowlatt J.* explained Lord *Cave's* phrase "for the enduring benefit of a trade" as meaning:<sup>28</sup>

...a benefit which endures, in the way that fixed capital endures; not a benefit that endures in the sense that for a good number of years it relieves you of a revenue payment. It means a thing which endures in the way that fixed capital endures. It is not always an actual asset, but it endures in the way that getting rid of a lease or getting rid of onerous capital assets...endures.

On appeal in that case *Romer L.J.* emphasised (quoted by *Richardson J.* in *McKenzies*) that the advantage did not need to be of a positive character: "The advantage may consist in the getting rid of an item of fixed capital that is of an onerous character, as was pointed out by this Court in *Mallett v Staveley Coal and Iron Co.*"<sup>29</sup> In *Staveley Coal and Iron Co.* two payments were made, one to persuade the landlord under a mining lease to accept the surrender of the lease and thus freeing the lessee from possible liabilities; the other payment to persuade the landlord to modify another lease. The mining leases were held to be fixed capital assets of the company and the payments received were capital payments.

(iv) Lord *Wilberforce* in *Granada Motorway Services* said, concerning *Anglo-Persian Oil* and the 'identifiable asset' test:<sup>30</sup>

Now there may not be much commercial difference between a payment of this kind [to end the agency agreement] and a payment to get rid of an onerous lease. But since the courts have accepted and worked the 'identifiable asset' test, the decision was no doubt right in law. The test may be to some extent arbitrary, but it provides a means which the courts can understand for distinguishing capital and income expenditure and I think that we would be wise to maintain it.

(v) He also commented that, in his opinion, the payment before him could not be regarded as payment of rent. To do so would be to confuse the measure, or basis of calculation of the payment with the nature of the payment.

(vi) Lord *Salmon* who dissented, was not persuaded that the lease was a

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<sup>28</sup>*Ibid.*, p. 262.

<sup>29</sup>(1928) 13 T.C. 772.

<sup>30</sup>[1979] 2 All E.R. 801 at p. 805.

capital asset. He also considered that the form in which the transaction was carried out aided the tenant by showing that the lump sum payment was in truth a payment of rent in advance.

(g) Case law and McKenzies. In addition to his discussion of *Tucker*, *Richardson J.*<sup>31</sup> cited the steps set out by *Rowlatt J.* for his reasoning in *Mallett v. Staveley Coal and Iron Co. Ltd.*:<sup>32</sup>

(i) When a colliery company acquires a lease, the expenditure of acquiring the lease is expenditure of acquiring a capital asset. It is capital expenditure.

(ii) When that lease is sold at an advantage, that receipt is on account of capital.

(iii) When the company pays to get rid of a disadvantageous lease, that is also a capital transaction.

*Richardson J.* further noted that the judgments on appeal in that case all proceeded on the footing that the leases were capital assets. The judgments on appeal emphasised the distinction between such fixed or permanent capital assets and circulating capital assets of a business. It was concluded that the expenses in question were outlays in respect of fixed capital.

He reiterated that *Tompkins J.* in the High Court had found that the lease was a capital asset, a finding which was not disputed. He stated that the form in which the transaction was carried, instead of showing that the lump sum payment was a payment of rent in advance, lead "inevitably to the conclusion" that the payment was made by McKenzies for the surrender of its entire interest under the lease.

His Honour dealt briefly with the case of *A. Leon Co. Ltd. v. Minister of National Revenue*<sup>33</sup> in which a surrender payment in respect of a lease was held to be a revenue expense. The Tax Appeal Board in a short judgment concluded that

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<sup>31</sup>(1988) 10 N.Z.T.C. 5233 at p. 5239.

<sup>32</sup>(1928) 13 T.C. 772 at p. 778

<sup>33</sup>(1961) 27 Tax A.B.C. 289.

rent payments under the leases in question were annual expenses. They were chargeable against revenue and the lump sum payments made in respect of the surrender of the leases was deductible. *Richardson J.* dismissed the case without further discussing it.

(h) Possible Contrary Arguments. Counsel for *McKenzies* submitted that the approach adopted in *Granada Motorway Services* should not be followed.

Counsel argued:

(i) By elevating the identifiable asset test above other tests, it posed an arbitrary test which created an artificial distinction between leases and other contracts under which revenue expenditure is incurred. The distinction lacked the commercial reality to which the Privy Council directed itself in the *B.P. Australia* case.

(ii) The enquiry should instead focus on the real effect of the payment: "what the expenditure is calculated to effect from a practical and business point of view", per *Hallstroms Pty. Ltd. v. F.C. of T.*<sup>34</sup>

Counsel relied strongly on the approach of *Gibson J.* in *Johnston Testers Ltd. v. Minister of National Revenue*<sup>35</sup> a judgment of the Exchequer Court of Canada.

The case concerned the deductibility of a payment made by the company to release it from a licence to use two patents. Royalty payments were payable by the company under the patents. *Gibson J.* distinguished the licence, held to be a capital asset and which gave the company the right to use the patents, from the employment of the machines which embodied the patents. He stated:<sup>36</sup>

The said release agreement in 1958 accomplished two things, namely, it got rid of the said capital asset, but the appellant paid no dollar consideration for this; and it got rid of the onerous annual payments of royalties to these licensors for use of the patents until 1972.

In other words, this latter was a payment to get rid of an annual charge against revenue in the future... The money was paid in the course of and for the

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<sup>34</sup>(1946) 72 C.L.R. 634 per *Dixon J.* at p. 648.

<sup>35</sup>[1965] C.T.C. 116.

<sup>36</sup>*Ibid.*, p. 127.



purpose of a continuing business, and the appellant did in fact after this payment and still does carry on the same business.

*Richardson J.* apparently did not see the facts as relevant to the case before him.

He cited a number of cases in which judges had not regarded the notion of a distinction between fixed and circulating capital as determining the income - capital issue. As *Gibbs J.* observed in *Commercial & General Acceptance Ltd. v. F.C. of T.*:<sup>37</sup> "The line of distinction between fixed and circulating capital is not precisely drawn, and it is of little advantage to try to answer one question by asking another to which the answer may be uncertain."

*Richardson J.* also discussed on this same point the comments of Viscount *Radcliffe* in *C. of T. v. Nchanga Consolidated Copper Mines Ltd.*<sup>38</sup> Viscount *Radcliffe* said as long as the expenditure in question could clearly be referred to the acquisition of an asset, which satisfied either of the accepted categories, such a test must be a critical one.

In short [*Richardson J.* states], in some circumstances it is appropriate to give very great weight to the ready identification and classification of the item in respect of which the payment is made as itself being held on capital account. It is in that sense that we understand Lord *Wilberforce* in *Granada Motorway Services* to endorse the identifiable asset test, and no doubt it, too, will yield in special cases where there are sufficient indicators pointing the other way, for example, where the right to possession of the premises for the remaining short period of the lease is considered worthless and the rent payments then made in advance are discounted to reflect the time of money.<sup>39</sup>

(i) His Honour's Conclusion: *Richardson J.* said the Court was satisfied that the payment was a capital expenditure.

The two crucial considerations which led to the conclusion were that the lease itself was a fixed capital asset and the consideration for the payment was the surrender by McKenzies of their interest in the lease. This *Richardson J.* said was the real effect of the transaction. The expenditure could not be described as a commutation payment.

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<sup>37</sup>(1977) 137 C.L.R. 373 at p. 377.

<sup>38</sup>[1964] A.C. 948 at p. 960.

<sup>39</sup>(1988) 10 N.Z.T.C. 5233 at p. 5241.

(5) Conclusion

The Court decided that:

(a) The various legislation dealing with leases did not deal with premiums paid or received on the surrender of a lease. Accordingly it would have been unsafe to have drawn any inference of a legislative purpose other than their character as capital or income fell to be determined on general taxation principles.

(b) The lease was a capital asset of the company. The lease was not held on revenue account. It was part of the profit-making structure of the business. If the lease was a capital item, in an uncomplicated case where the lump sum payment made was seen as the cost of disposing of that capital item, the expenditure involved ought to be regarded as capital expenditure. Likewise a lump sum payment made in consideration for the surrender of a lease that was held on capital account should be regarded as expenditure of capital.

(c) The true agreement between the parties was represented in the Deed of Surrender. It was the surrender of the entire interest under the lease that was the subject of the lump sum payment made by McKenzies. Accordingly in principle the payment should have been regarded as capital expenditure.

Looking to the future, the case is strong authority for the view that a lease incentive is a capital receipt in the hands of the lessee on the basis of the close association between the lease, a capital asset, and the lease incentive. This view is supported by the *Thomas Borthwick*<sup>40</sup> case.

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<sup>40</sup>*C. of I.R. v. Thomas Borthwick & Sons (Australasia) Ltd*, (1992) 14 N.Z.T.C. 9101.

## CHAPTER IV

## THE CANADIAN CASES

A line of cases decided by the Canadian courts generally supports the view that lease incentives are capital.

*Maison de Choix Inc. v. M.N.R.*<sup>1</sup> concerned a taxpayer who was a retail merchant renting space in a number of shopping centres. Developers paid the taxpayer inducements to enter into several leases. The Tax Review Board ruled the payments to be of a capital nature. The payments were not disguised forms of rent reduction. They were justified by the tenant's capacity to attract clientele and its business expertise.

In *French Shoes Ltd. v. R.*<sup>2</sup> the Court reached a different conclusion. The taxpayer, a shoe store operator, was paid a \$50,000 cash inducement by a developer to lease premises in a shopping centre. The incentive was "to be applied against its inventory". The judge held the payment was business income:

Although each case must be judged on the facts of that particular case, I am of the opinion that incentive payments, inducements, generally form part of the revenue of the taxpayer. The payment is received as a result of the business activity carried on by the taxpayer and would have not otherwise been received.

The judge found "that a very important part of the company's business [was] in the negotiation of leases". The company had 22 stores leased. The reasoning of the Court bears a similarity to that of *Hill J. in Cooling*.<sup>3</sup>

In *Westfair Foods Ltd. v. R.*<sup>4</sup> payments made to the taxpayer for the early termination of leases were held to be capital and not taxable to the former tenant.

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<sup>1</sup>83 D.T.C. 204.

<sup>2</sup>86 D.T.C. 6359.

<sup>3</sup>*F.C. of T. v. Cooling* 90 A.T.C. 4472.

<sup>4</sup>91 D.T.C. 5073.

This is consistent with the results in *McKenzies* and *Kennedy Holdings*. The Court declined to follow *French Shoes*. In the course of the decision *Reed J.* stated:

...it is not sufficient to say, as Counsel would have me conclude on the basis of that case [*French Shoes Ltd*], that merely because the signing of leases is related to the plaintiff's business, the determination payment in the circumstances of the present case, should therefore be characterised as an income receipt. Such a rule would wipe out all distinction between capital assets and income. All capital receipts and capital expenditures are related to the taxpayer's business in some way or other.

This passage echoes statements made in Australia in the *Spedley* case *Reed J.* continued:

[The plaintiff] points out that it is not in the business of buying and selling leases. It does not trade in leases. The head leases in its hands are capital assets. It needs physical premises from which to conduct its food and distribution and sales business and these are obtained either by outright ownership of the premises or by way of long term leases.

The other Canadian decision of note is the decision of the Federal Court of Canada in *Woodward Stores Ltd. v. R.*<sup>5</sup> The case concerned a well-known general merchandiser who operated 24 department stores. The developer of two shopping centres desired the plaintiff to enter two long term leases in respect of the two locations. After negotiation an inducement called a "fixturing allowance" of \$3.75 million was paid on account of the two locations. The plaintiff on taking possession of the premises expended \$6.658 million on one location and a further \$4.9 million on the other location on fixtures before it opened for business. The judgment involved an extensive consideration of the earlier cases including those mentioned here. The judge rejected the *French Shoes* approach where the payment "was for purposes of inventory, clearly a non-capital expense" and followed the *Westfair Foods'* case. He held the incentive payments were on capital account.

These Canadian cases, except for *French Shoes*, support the conclusion that a lease incentive is capital. We will however have to wait and see what weight these cases will be given, if any, by the New Zealand courts when they consider the tax treatment of a lease incentive. Obviously lessees will argue that the principles in these cases are applicable in New Zealand.

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<sup>5</sup>91 D.T.C. 5090.

## CONCLUSION

The Australian decision of *F.C. of T. v The Myer Emporium Ltd.*<sup>1</sup> has required a re-appraisal of the traditional distinctions between matters on revenue account and matters on capital account discussed in Part A.

It has been argued that the decision has extended the reach of the concept of income by treating as income any gain made in the course of business operations. The only exception being a gain that is "extraordinary, judged by reference to the course of carrying on the profit-making business".<sup>2</sup> This broad interpretation of Myer has found favour in some decisions. It has however been rejected in a number of other decisions including *Spedley*<sup>3</sup> and *Westfield*.<sup>4</sup>

The greatest impact the decision has had is on the concept of business. The Australian courts appear to have adopted the *Myer* approach and taken what can be described as a very broad view of what forms part of the taxpayer's business. The result has and will be that fewer receipts will fall outside the enlarged concept of the taxpayer's business. Hence we have the decision of *Cooling*<sup>5</sup> where a lease incentive provided to a firm of solicitors was derived "in the course of its business activity".<sup>6</sup> One or two decisions such as *Westfield*<sup>7</sup> and *Hyteco*<sup>8</sup> have however taken a more restrictive view of the business activities of the taxpayer.

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<sup>1</sup>87 A.T.C. 4363.

<sup>2</sup>*Ibid.*, p. 4370.

<sup>3</sup>*F.C. of T. v. Spedley Securities Ltd.* 88 A.T.C. 4126.

<sup>4</sup>*Westfield Ltd v. F.C. of T.* 90 A.T.C. 4801.

<sup>5</sup>*F.C. of T. v. Cooling* 90 A.T.C. 4472.

<sup>6</sup>*Ibid.*, 4484.

<sup>7</sup>90 A.T.C. 4801.

<sup>8</sup>*F.C. of T. v. Hyteco Hiring Ltd.* 92 A.T.C. 4694.

It is unclear whether the New Zealand courts will apply the principles in *Myer* and *Cooling* to the taxation of lease incentives.

The current approach of the New Zealand Court of Appeal in distinguishing between income and capital is exemplified in the *McKenzies*<sup>9</sup> and *Borthwicks*<sup>10</sup> cases. *Richardson J.* in *McKenzies* stated a lease is a capital asset. On this basis it can be argued in an uncomplicated case, a lease incentive is a capital receipt as it relates to a capital asset.

There is no mention of *Myer* and *Cooling* in either of these decisions. It has been suggested<sup>11</sup> that this amounts to an implicit rejection of the approach taken in those two cases.

At the end of the day, for any answer as to whether a lease incentive in New Zealand is assessable we will have to wait until the issue comes before the courts in New Zealand.

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<sup>9</sup>*C. of I.R. v. McKenzies N.Z. Ltd.* (1988) 10 N.Z.T.C. 5233.

<sup>10</sup>*C. of I. R. v. Thomas Borthwick & Sons (Australasia) Ltd.* (1992) 14 N.Z.T.C. 9101.

<sup>11</sup>*New Zealand Master Tax Guide* (1993) C.C.H. New Zealand Ltd., p. 370.

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